Supreme Court, U.S.
FILED
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No. 00-592

IN THE

SUPREME COURT OF THE UNITED STATES

IVOR F. BENCI-WOODWARD and
DEBRA A. BENCI-WOODWARD,
LAURENTZ J. MANGUM and BARBARA MANGUM,
JOSE RAGATZ and DIANNE M. RAGATZ,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

[FOR PUBLICATION]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 99-70136
Tax Ct. No. 3769-96

IVOR F. BENCI-WOODWARD and
DEBRA A. BENCI-WOODWARD,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 99-70138
Tax Ct. No. 4185-96

LAURENTZ J. MANGUM and
BARBARA MANGUM,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 99-70137
Tax Ct. No. 8265-96

JOSE RAGATZ and DIANNE M. RAGATZ,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

OPINION

Appeals from the United States Tax Court
Arthur L. Nims, III, Tax Court Judge, Presiding

Submitted June 8, 2000[1]
Pasadena, California

Filed July 18, 2000

Before: Stephen S. Trott, Ferdinand F. Fernandez, and M. Margaret McKeown, Circuit Judges.

Opinion by Judge McKeown

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[1] The panel unanimously finds this case suitable for decision without oral argument. *See* Fed. R. App. P. 34(a)(2).

SUMMARY

Tax/Income

The court of appeals affirmed a decision of the tax court. The court held that under California law, taxpayers may not exclude from gross income the portion of punitive damages award retained by their attorney pursuant to a contingent fee agreement.

Appellant employees of Target Stores, filed an action in California state court against Dayton-Hudson, Inc. The employees entered into a contingent fee agreement with their attorney that gave him a lien on any recovery in the case.

A jury returned a verdict for the employees that included both compensatory and punitive damages. They failed to report the punitive damages award as taxable income. They argued before the tax court that the portion of those damages retained by their attorney as fees and costs should have been excluded from their gross income.

The tax court ruled that all of the punitive damages were includable in gross income, without an offset for attorney fees and costs, and that, as miscellaneous itemized deductions, the contingent fees were subject to disallowance as a result of the application of the Alternative Minimum Tax (AMT).

The employees appealed.

Under California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients. The attorney fee portion of the punitive damages recovery was taxable to the employees.

As legal expenses are not enumerated in 26 U.S.C. §67(b), they are classified as miscellaneous itemized deductions. Section 56(b) is clear that no deduction shall be allowed for any miscellaneous itemized deductions. The punitive damages retained by the employees' attorney pursuant to a contingency agreement were miscellaneous itemized deductions were not allowed as deductions for purposes of computing AMT liability.

COUNSEL

Philip Garrett Panitz and Ryan D. Schaap, Law Offices of Philip Garrett Panitz, Westlake Village, California, for the petitioners.

Teresa E. McLaughlin and Tamara W. Ashford, Tax Division, Department of Justice, for the respondent.

OPINION

McKEOWN, Circuit Judge:

The question before us is whether the taxpayers may exclude from gross income the portion of a punitive damages award retained by their attorney pursuant to a contingent fee agreement. The answer is no and is dictated by our recent case of *Coady v. Commissioner*, ___ F.3d ___, No. 98-71358, 2000 WL 763843 (9th Cir. June 14, 2000). Although *Coady* involved analysis of an attorney lien under Alaska law, the result is the same under California law. We have jurisdiction pursuant to 26 U.S.C. §7482(a)(1), and we affirm the decision of the Tax Court.

BACKGROUND

Petitioners, who were employees of Target Stores, filed a lawsuit in California state court against Dayton-Hudson, Inc. (of which Target is a division) and Dana Pereau. The complaint, stemming from events arising out of an employer investigation, alleged false imprisonment, defamation, intentional infliction of emotional distress, wrongful discharge in violation of public policy, breach of an implied-in-fact employment contract, breach of the implied covenant of good faith and fair dealing, constructive discharge, and intentional misrepresentations. In connection with their legal representation, Petitioners entered into a Retainer Agreement with their attorney that provided for a contingent fee arrangement and that gave him a lien on any recovery in the case.

Following trial, a jury returned a verdict in favor of Petitioners. The award included both compensatory and punitive damages. Petitioners did not initially report their punitive damages award as taxable income, but have since conceded that the portion of those damages retained by their attorney as fees and costs should be excluded from gross income. The Tax Court disagreed, ruling that all of the punitive damages were fully includable in Petitioners' gross income without an offset for attorney fees and costs. The Tax Court further ruled that, as miscellaneous itemized deductions, the contingent fees are subject to disallowance as a result of the application of the Alternative Minimum Tax ("AMT").

DISCUSSION

We review de novo the Tax Court's conclusions of law. *Ferguson v. Commissioner*, 174 F.3d 997, 1001 (9th Cir. 1999). Under California law, an attorney lien

does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients. The California Supreme Court explained that

> in whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a security interest in the proceeds of the litigation. . . . While there is occasional language in cases in the effect that the attorney also becomes the equitable owner of a share of the client's cause of action, we stated more accurately in *Fifield Manor v. Finston* (1960) 54 Cal.2d 632, 641, 7 Cal. Rptr. 377, 383, 354 P.2d 1073, 1079, 78 A.L.R.2d 813, that contingent fee contracts "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery."
>
> * * *
>
> [T]he conclusion emerges that in litigation an attorney conducts for a client he acquires no more than a professional interest. To hold that a contingent fee contract or any "assignment" or "lien" created thereby gives the attorney the beneficial rights of a real party in interest, with the concomitant personal responsibility of financing the litigation, would be to demean his profession and distort the purpose of the various acceptable methods of securing his fee.

Isrin v. Superior Court, 403 P.2d 728, 732, 733 (Cal. 1965); *see also id.* at 734 ("The fact that[the attorney] has a right by contract to participate in the proceeds of any judgment does not make him in any true sense of the word a party in interest."); *Cooper v. Equity Gen. Ins.*, 219 Cal. App. 3d 1252, 1260 (1990) ("A contingent fee contract does not transfer to the attorney any rights to

the client's cause of action, but rather gives the attorney a lien on the client's prospective recovery."). *Cf. Estate of Clarks v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000) (stating that under Michigan law, attorney becomes a 'tenant in common' of the litigation).

In light of California law, our holding here—that the attorney fee portion of the punitive damages recovery is taxable to Petitioners—is compelled by our analysis in *Coady*. *See* 2000 WL 763843 at *4 (holding that Alaska law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients," concluding that contingent fees and costs were not excludable from gross income, and distinguishing *Estate of Clarks* and *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959)).[2]

We also reject Petitioners' contention that the portion of the recovery paid to their attorney is not subject to disallowance as a result of the application of the AMT. The starting point is the interpretation of 26 U.S.C. §67, which imposes a 2-percent floor on miscellaneous itemized deductions of individuals. 26 U.S.C. §67(a). Miscellaneous itemized deductions are defined as those itemized deductions that are not specifically enumerated within section 67(b). Legal expenses are not so enumerated and thus are classified as miscellaneous itemized deductions. This result follows from the plain language

---

[2]Petitioners' effort to distinguish contingent fees from other anticipatory assignments of income due to the uncertainty of their realization is foreclosed by *Coady*. *See* 2000 WL 763843 at *5 ("[T]he fact that such an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it.").

of the statute and Petitioners cite no authority to the contrary. The next question is whether miscellaneous itemized deductions are allowed for purposes of computing the AMT. Section 56(b) is crystal clear that "[n]o deduction shall be allowed . . . for any miscellaneous itemized deduction." 26 U.S.C. §56(b)(1)(A). The Tax Court correctly determined that the legal expenses at issue here are miscellaneous itemized deductions, *see* 26 U.S.C. §67(b), and as such are not allowed as deductions for purposes of computing AMT liability, *see* 26 U.S.C. §56(b)(1)(A)(i).

Petitioners also argue that the AMT results in inequities to certain taxpayers; such considerations, however, are more appropriately left for congressional resolution. *See Alexander v. IRS*, 72 F.3d 938, 946-47 (1st Cir. 1995) (recognizing that, although application of AMT to legal fees may result in a seemingly unfair outcome, "there is [n]o inequality of treatment as compared to similarly situated taxpayers . . . [and i]t is well established that equitable arguments cannot overcome the plain meaning of the statute"); *Weiser v. United States*, 959 F.2d 146, 148-49 (9th Cir. 1992) (rejecting taxpayer challenge to disallowance of deductions under AMT on inequity grounds); *see generally Okin v. Commissioner*, 808 F.2d 1338, 1342 (9th Cir. 1986) (upholding constitutionality of AMT).

AFFIRMED.

APPENDIX B

T.C. Memo. 1998-395

UNITED STATES TAX COURT

IVOR F. AND DEBRA A. BENCI-WOODWARD, ET AL.,[1] Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 3769-96, 4185-96, 8265-96.

Filed November 9, 1998.

In these consolidated cases, R determined deficiencies in Ps' Federal income taxes for their 1992 taxable year due to their failure to include in gross income certain punitive damages and interest arising out of a State court lawsuit. (Ps now concede that all amounts received as punitive damages, plus interest, are includable in gross income as determined by R. See *O'Gilvie v. United States*, 519 U.S. 79 (1996).) R allowed Ps miscellaneous itemized deductions for legal fees and costs attributable to their punitive damages awards pursuant to sec. 67, I.R.C. However, in computing Ps' alternative minimum tax (AMT) adjustments, R disallowed their miscellane-

[1] Cases of the following petitioners are consolidated herewith: Laurentz J. and Barbara Mangum, docket No. 4185-96, and Jose and Dianne M. Ragatz, docket No. 8265-96.

ous itemized deductions pursuant to sec. 56(b) (A) (i), I.R.C.

1. *Held*: Ps' deductions for legal expenses attributable to punitive damages are miscellaneous itemized deductions, deductible to the extent they exceed 2 percent of adjusted gross income. Sec. 67, I.R.C; sec. 1.67-1T (a) (1) (ii), Temporary Income Tax Regs., 53 Fed. Reg. 9875 (Mar. 28, 1988).

2. *Held, further,* miscellaneous itemized deductions for legal expenses related to punitive damage awards are not allowed for purposes of calculating AMT. Sec. 56 (b) (1) (A) (i), I.R.C.; *Alexander v. Commissioner,* 72 F.3d 938 (1st Cir. 1995), affg. T.C. Memo. 1995-51, applied.

3. *Held, further,* Ps' gross income includes their punitive damage awards unreduced by attorney's fees (and costs). *Cotnam v. Commissioner,* 263 F.2d 119 (5th Cir. 1959), affg. in part and revg. in part 28 T.C. 947 (1957), distinguished.

Philip Garrett Panitz, for petitioners.

Mark A. Weiner, for respondent.

MEMORANDUM OPINION

NIMS, *Judge*: In these consolidated cases, respondent determined the following deficiencies with respect to the Federal income taxes of petitioners Ivor F. and Debra A. Benci-Woodward (the Benci-Woodwards), Laurentz J. and

Barbara Mangum (the Mangums), and Jose and Dianne M. Ragatz (the Ragatzes):

Docket No. 3769-96
(the Benci-Woodwards)

Year	*Deficiency*
1992	$321,002

Docket No. 4185-96
(the Mangums)

Year	*Deficiency*
1992	$314,873

Docket No. 8265-96
(the Ragatzes)

Year	*Deficiency*
1992	$316,965

Unless otherwise indicated, all section references are to sections of the Internal Revenue Code in effect for the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure. All dollar amounts are rounded to the nearest dollar.

After concessions by petitioners, the issues remaining for decision are: (1) Whether legal expenses attributable to petitioners' receipt of punitive damages constitute miscellaneous itemized deductions within the meaning of section 67(b); if so, (2) whether such deductions are subject to disallowance for purposes of computing petitioners' alternative minimum tax (AMT) liability; and (3) whether attorney's fees and costs may be excluded from gross income under the facts of this case.

These cases were submitted fully stipulated. The petitioners resided in California at the time they filed their petitions.

Background

Ivor F. Benci-Woodward (Benci-Woodward), Laurentz J. Mangum (Mangum), and Jose Ragatz (Ragatz) (collectively referred to herein as the plaintiffs) filed a lawsuit (lawsuit) against Dayton-Hudson, Inc. (Dayton-Hudson), and Dana Pereau (Pereau) (collectively referred to herein as the defendants). Plaintiffs brought the following causes of action, among others, against the defendants: False imprisonment, fraud, defamation, intentional infliction of emotional distress, wrongful discharge, and breach of contract.

In connection with the lawsuit, Benci-Woodward, Mangum, and Ragatz each entered into a Retainer Agreement (Agreement) with John H. Howard, an attorney, which empowered him to "handle any and all legal proceedings arising out of said incidents", and further provided, among other things, that

> Client agrees to pay Attorney for services a sum equal to forty percent (40%) of any amounts received or recovered in this matter on behalf of Client. Attorney may retain his share out of the amount finally collected by settlement or judgment, herein termed "recovery", in full for the services and any advanced costs.
>
> Attorney is given a first lien and assignment on any recovery however procured to the extent of this contract and such amounts may be retained therefrom. Attorney is given a further lien and assignment on any sums recovered herein for fees incurred for all legal work performed for client whatsoever and such amounts shall be in addition to the contingent fee and costs provided for in this agreement.

A jury trial was held before Judge Melinda A. Johnson of the Superior Court of California, County of Ventura,

on April 23, 1990. Verdict was entered on July 11, 1990. In addition to awards for compensatory damages, each plaintiff was awarded punitive damages in the amount of $1,190,000, plus interest, from Dayton-Hudson. Furthermore, Ragatz and Mangum were each awarded punitive damages in the amount of $16,000 from Pereau, plus interest, and Benci-Woodward was awarded $12,000 in punitive damages, plus interest, from Pereau. Dayton-Hudson paid its portion of both the compensatory and punitive damage awards in full to Howard's trust account.

According to a Breakdown dated October 8, 1992, supplied by Howard to Benci-Woodward, the latter was entitled to receive a net combined amount from Dayton-Hudson and Pereau of $915,097, consisting of judgment amounts, interest, and costs paid by Dayton-Hudson, less attorney's fees and certain costs advanced by Howard and another. The $915,097 was disbursed by Howard to Benci-Woodward out of the trust account.

According to a Breakdown dated October 8, 1992, supplied by Howard to Ragatz, the latter was entitled to receive a net combined amount from Dayton-Hudson and Pereau of $881,226, consisting of judgment amounts, interest, and costs paid by Dayton-Hudson, less attorney's fees, costs advanced by Howard, and certain other miscellaneous items. The $881,226.03 was disbursed by Howard to Ragatz out of the trust account.

The details of the disbursement to Mangum are not in the record.

Petitioners did not report their punitive damages awards as taxable income on their respective 1992 tax returns, although the Benci-Woodwards and the Mangums disclosed the awards on their returns. In addition, peti-

tioners did not report in full their interest on punitive damages on their respective 1992 returns.

Respondent timely issued notices of deficiency to petitioners. Among other adjustments, respondent determined that punitive damages and related interest were fully includable in petitioners' gross income pursuant to section 61. Petitioners have since conceded that their punitive damages, and related interest, are includable in gross income in the amounts determined by respondent. See *O'Gilvie v. United States,* 519 U.S. 79 (1996).

Respondent also determined that the Benci-Woodwards, the Mangums, and the Ragatzes were entitled to miscellaneous itemized deductions, subject to the 2-percent floor provided by section 67(a), for attorney's fees and costs attributable to the punitive damages awards in the amounts of $670,135, $626,448, and $609,767, respectively. However, for AMT purposes, respondent disallowed petitioners' miscellaneous itemized deductions for legal fees completely, and determined AMT liability for the Benci-Woodwards, the Mangums, and the Ragatzes in the respective amounts of $85,009, $73,787, and $75,694.

Howard reported on Schedule C, Profit or Loss From Business (Sole Proprietorship), attached to his 1992 individual tax return as gross receipts from his legal practice all of the attorney's fees he received from plaintiffs.

Discussion

The dispute here concerns the appropriate treatment for the legal fees and costs attributable to punitive damages that the plaintiffs incurred in pursuing their lawsuit against the defendants. Section 67(a) imposes a 2-percent floor on the miscellaneous itemized deductions of individuals for all taxable years beginning after December 31,

1986. In other words, miscellaneous itemized deductions may be taken only to the extent that they exceed 2 percent of an individual taxpayer's adjusted gross income. Miscellaneous itemized deductions are defined in section 67(b) as those itemized deductions that are not specifically enumerated therein. Legal expenses related to the production or collection of income and thereby deductible under section 212 (1), as here, are not specifically enumerated in section 67(b).

Petitioners argue that Congress never intended legal expenses attributable to punitive damages to fall within the category of miscellaneous itemized deductions. In that connection, petitioners maintain that

> Since punitive damage awards were not definitively determined to be taxable until recently, there was no prior need for a determination that attorney fees should be allowed as an itemized deduction excluded from the miscellaneous itemized deduction "catch-all" of section 67(b).

Petitioners cite no authority in support of their proposition, and their argument is, in fact, untenable. The treatment of legal expenses attributable to punitive damages as miscellaneous itemized deductions results from the purely mechanical application of section 67. Moreover, such treatment accords with the treatment of legal fees attributable to damages awarded in, or settlements connected with, contractual disputes, for example, which have always been subject to tax. *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), affg. T.C. Memo. 1995-51; see also *Brewer v. Commissioner*, T.C. Memo. 1997-542 (holding that a deduction for legal fees attributable to settlement of Title VII gender discrimination suit is a miscellaneous itemized deduction subject to the 2-percent floor); *Glassman v. Commissioner*, T.C. Memo.

1997-497 (holding that section 212 deduction for legal fees is a miscellaneous itemized deduction subject to section 67 (a)).

Had Congress intended to except legal fees attributable to taxable punitive damages from the 2-percent limitation of section 67 (a), it easily could have done so. It did not, and we must interpret the statute as it is written. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989); see also *Estate of Young v. Commissioner*, 81 T.C. 879, 890 (1983) (Chabot, J., concurring), where it is observed that "our task is to interpret the statute that the Congress enacted and not to guess at what the Congress would have done had it faced the matter we deal with in the instant case".

We hold that legal expenses incurred in connection with the receipt of punitive damages constitute miscellaneous itemized deductions within the meaning of section 67 (b). Having so held, we must also decide whether miscellaneous itemized deductions for legal expenses related to receipt of punitive damages are subject to disallowance pursuant to section 56(b) (1) (A) (i) for purposes of computing petitioners' AMT.

Since 1969, the Internal Revenue Code has included minimum tax provisions for both corporate and individual taxpayers. Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487. Congress enacted the minimum tax to prevent corporate and individual taxpayers from aggregating deductions to the point where they pay either no tax or a "shockingly low" tax. *First Chicago Corp. v. Commissioner*, 842 F.2d 180, 181 (7th Cir. 1988), affg. 88 T.C. 663 (1987).

The post-1986 AMT rules, codified as sections 55 through 59, were enacted to achieve one overriding objec-

tive: To establish a floor for tax liability, so that a taxpayer pays some tax regardless of the tax benefits available to him under the regular income tax (RIT). See S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 515, 518. The AMT is paid only if, and to the extent that, it exceeds the taxpayer's RIT. Sec. 55(a). Computing AMT liability begins with determining alternative minimum taxable income (AMTI). AMTI is computed in the same manner as regular taxable income except that the adjustments provided in sections 56 and 58 are taken into account for AMTI, and so-called tax preference items set forth in section 57 are not permitted to reduce AMTI. Sec. 55(b) (2).

Section 56(b) provides as follows:

> (b) Adjustments Applicable to Individuals.—In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (*in lieu of* the treatment applicable for purposes of computing the regular tax):
>
> (1) Limitations on deductions.—
>
> (A) In general.—No deduction shall be allowed—
>
> (i) for *any* miscellaneous itemized deduction (as defined in section 67(b)) * * * [Emphasis added.]

Thus, since we have already concluded that the legal expenses at issue are miscellaneous itemized deductions within the meaning of section 67(b), it follows that they are not allowed for purposes of computing petitioners' AMT liability. *Alexander v. Commissioner, supra*; sec.

56(b) (1) (A) (i); sec. 1.67-1T(a) (1) (ii), Temporary Income Tax Regs., 53 Fed. Reg. 9875 (Mar. 28, 1988).

Petitioners acknowledge that section 56(b) (1) (A) (i) expressly disallows miscellaneous itemized deductions for purposes of computing AMT. However, petitioners alternatively assert that the application of the AMT in the instant cases unfairly creates "a circumstance of double taxation", inasmuch as petitioners and attorney Howard must pay tax on the same amount recovered from the defendants. Petitioners' argument on this score is unavailing. See, e.g., *Alexander v. Commissioner, supra* at 947 ("It is well established that equitable arguments cannot overcome the plain meaning of the statute.").

We hold that petitioners' legal expenses are miscellaneous itemized deductions subject to disallowance pursuant to section 56(b) (1) (A) (i) for purposes of computing petitioners' AMT liability for their 1992 taxable years.

Petitioners argue in the alternative that they are in the "identical position as the taxpayers in *Cotnam* and *Davis.*" See *Cotnam v. Commissioner,* 263 F.2d 119 (5th Cir. 1959), affg. in part and revg. in part 28 T.C. 947 (1957); *Davis v. Commissioner,* T.C. Memo. 1998-248. While as to the salient facts this may be true, petitioners' legal position is not the same.

In *Cotnam v. Commissioner, supra* at 125, the Court of Appeals for the Fifth Circuit concluded that under 46 Ala. Code sec. 64 (1940), attorneys have the same right over "suits, judgments, and decrees for money" as their clients, so the taxpayer in that case did not realize income as to her attorneys' interests of 40 percent in her cause of action and judgment. *Davis v. Commissioner, supra,* involving the case of a taxpayer who was a resident of Alabama, followed *Cotnam.* See *Golsen v. Commis-*

sioner, 54 T.C. 742 (1910), affd. 445 F.2d 985 (10th Cir. 1971).

The law of Alabama, as analyzed in *Cotnam*, is not the law of California, the State of petitioners' residence during all times relevant here. The parties have not brought to our attention any statute of California regulating attorney's liens, and we are aware of none. Nevertheless, the case law of California is clear that liens for attorney's fees, whether created expressly or implied from a retainer agreement, do not transfer to the attorney an ownership or proprietary interest in the client's cause of action. In an en banc opinion, *Isrin v. Superior Court of Los Angeles County*, 403 P.2d 728, 732 (Cal. 1965), the Supreme Court of California concluded that contingent fee agreements "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery."

Petitioners also argue that cases which have addressed the taxability of punitive damages have consistently analyzed those damages net of attorney's fees and costs. Petitioners cite *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994); *O'Gilvie v. United States*, 66 F.3d 1550 (10th Cir. 1995), affd. in part, revd. on the issue of taxability of punitive damages 519 U.S. 79 (1996); and *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990), revg. and remanding 93 T.C. 330 (1989), supplemented by T.C. Memo. 1993-49.

In both *Hawkins v. United States, supra*, and *O'Gilvie v. United States, supra*, the respective Courts appear to have accepted, without further consideration or discussion, the premise that the question to be resolved was the taxability of punitive damages, *net* of attorney's fees and costs. In *Commissioner v. Miller, supra*, the Court of Appeals for the Fourth Circuit reversed a prior Tax Court

decision holding that punitive damages are exempt from tax. The taxpayer had obtained a jury verdict awarding $500,000 in conpensatory damages and $450,000 in punitive damages, which was settled for an overall amount of $900,000, the taxpayer receiving a net of $525,000 after attorney's fees and costs. On remand, the Court of Appeals provided the Tax Court with instructions on possible methods of valuing the punitive damage portion of the settlement, stating that "It is appropriate for the case to be remanded to the Tax Court to permit a determination as to what portion of the $900,000 gross amount in settlement (*reduced to $525,000 net*) was attributable to punitive damages." *Id.* at 592. (Emphasis added). The Court of Appeals does not explain its reason for reducing the $900,000 gross amount to the $525,000 net amount, before the directed allocation between punitive and compensatory damages.

With the exception of *Cotnam v. Commissioner, supra,* and *Davis v. Commissioner, supra* (which, as noted, followed *Cotnam* under the *Golsen* rule), courts, when directly confronted with the question, have uniformly rejected the contention that taxpayers may exclude the amount of their legal fees and costs from gross income in cases such as the one before us. Since the courts in the 3 cases cited by petitioners were not so confronted, and therefore did not have the occasion to focus directly on the issue, we decline to accept those cases as precedent for the proposition that petitioners' gross income is to be determined net of their attorney's fees (and costs). For examples of recent cases which have distinguished *Cotnam,* see *Sinyard v. Commissioner,* T.C. Memo. 1998-364; *Srivastava v. Commissioner,* T.C. Memo. 1998-362; and *Coady v. Commissioner,* T.C. Memo. 1998-291, and additional cases cited therein. We hold that petitioners'

gross income includes their punitive damage awards unreduced by their attorney's fees (and costs).

To reflect the foregoing and petitioners' concessions,

Decisions will be entered for respondent.

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 16902

ETHEL WEST COTNAM,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

263 F.2d 119; 1959 U.S. App. LEXIS 4527;
59-1 U.S. Tax Cas. (CCH) P9200;
3 A.F.T.R.2d (RIA) 527; 70 A.L.R.2d 1035

January 23, 1959

COUNSEL:

Winston B. McCall, William S. Pritchard, Birmingham, Ala. (Victor H. Smith, Pritchard, McCall & Jones, Birmingham, Ala. of counsel), for petitioner.

James P. Turner, Melva M. Graney, Lee A. Jackson, Dept. of Justice, Washinton, D.C., Charles K. Rice, Asst. Atty. Gen., Charles P. Dugan, Special Atty., Int. Rev. Serv., Washington, D.C., Nelson P. Rose, Chief Counsel, Int. Rev. Serv., Washington, D.C., for respondent.

JUDGES:

Before RIVES, BROWN and WISDOM, Circuit Judges.

OPINION BY:
WISDOM

OPINION:

The tax snarls in this case are a result of a contract to make a will and the promisee's successful suit against the promisor's estate for breach of that contract.

In 1940 T. Shannon Hunter of Mobile, Alabama promised to give Mrs. Ethel Cotnam one-fifth of his estate, if she would serve him as an attendant or friend[1] for the rest of his life. Mrs. Cotnam quit her job at the Saenger Theatre, Left her home in Springhill, moved to Mobile, and served T. Shannon Hunter faithfully as attendant and friend until he died four and a half years later. He died without a will. In 1948, after a long, hard-fought suit against the Administrator of the Estate of T. Shannon Hunter, the Supreme Court of Alabama upheld the validity of Mrs. Cotnam's contract with Hunter and awarded her a judgment of $120,000.[2] Attorneys' fees were $50,365.83. The Commissioner of Internal Revenue determined a deficiency in income tax against Mrs. Cotnam of $36,985.02.

The Commissioner treated the $120,000 as taxable income and, in accordance with Section 107 of the Internal Revenue Code of 1939, apportioned the sum over the

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[1] Mrs. Cotnam's amended claim in the Alabama Circuit Court proceedings stated that she was 'to render services and attention as an attendant or friend'.

[2] Two questions of fact were submitted to the jury: '(1) Whether such a contract as claimed was in fact made; and (2) Whether any part of the consideration of such contract was illicit sexual relations'. The jury answered 'Yes' to the first question and 'No' to the second question. The Alabama Supreme Court held that the verdict was 'well supported by the evidence'. *Merchants National Bank of Mobile v. Cotnam, 1948, 250 Ala. 316, 34 So.2d 122, 132.*

four and a half year period when Mrs. Cotnam served as Hunter's attendant. The Commissioner allowed a deduction for attorneys' fees for 1948.

The Tax Court upheld the Commissioner. *28 T.C. 947.* The case is before us on the taxpayer's petition for review of the Tax Court decision.

(1) This Court is asked to decide whether the sum of $120,000 paid Mrs. Cotnam was exempt as a bequest or was taxable income for services rendered. (2) If the sum was income to Mrs. Cotnam, secondary questions arise as to the attorneys' fees: (a) Should the amount paid the attorneys from the judgment in favor of Mrs. Cotnam be excluded from the taxpayer's gross income, on the theory that it was not income to her? (b) If included in the taxpayer's income, should the attorneys' fees be apportioned ratably over the four and a half years Mrs. Cotnam served Hunter or should the entire amount be deducted as an expense in 1948, the year it was paid?

This Court is unanimously of the opinion that the amount Mrs. Cotnam received was taxable income to her. A majority of the Court hold that the sum paid the attorneys was not taxable income to Mrs. Cotnam.

I.

Section 22(b)(3) of the Internal Revenue Code of 1939, *26 U.S.C.A. 22*(b)(3), provides that the value of property acquired 'by gift, bequest, devise, or inheritance' shall be excluded from gross income. The taxpayer argues that under Alabama law the contract operated as a will, she assumed the status of a legatee, the amount she received was a bequest and exempt from federal income tax.

State law determines what property rights and interests a taxpayer has, but federal law determines the conse-

quences of such rights and interests for tax purposes. The meaning of 'gift, bequest, devise, or inheritance' in federal revenue laws is a matter of federal law. *Lyeth v. Hoey, 1938, 305 U.S. 188, 59 S.Ct. 155, 158, 83 L.Ed. 119.* In the Lyeth case the court held:

'The question as to the construction of the exemption in the federal statute (section 22(b)(3)) is not determined by local law. Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. There is no such expression or necessary implication in this instance.'

The court was specifically concerned with the meaning of the term 'inheritance', but also implied that a judgment enforcing a contract to make a will could in some cases operate as a bequest.

'In exempting from the income tax the value of property acquired by 'bequest, devise, or inheritance', Congress used comprehensive terms embracing all acquisitions in the devolution of a decedent's estate. If in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act.'

The nature of the transaction underlying the judgment, not the judgment itself, controls the tax effects. *United States v. Safety Car Heating Co., 1936, 297 U.S. 88, 56 S.Ct. 353, 80 L.Ed. 500; Arcadia Refining Co. v. Commissioner, 5 Cir., 1941, 118 F.2d 1010.* The amount received is taxable or nontaxable according to what it represents. If the judgment was for an amount due under a contract for personal services, a reference in the judgment or the opinion supporting it to the sum recovered as

'in the nature of a bequest' will not change the compensation from taxable income to an exempt bequest. Thus, in order to acquire property by inheritance, a party must bring suit against the estate as an heir. He must participate in the proceeds as an heir. One seeking to acquire property by bequest stands on the same side of the fence. He must sue as a legatee.

A contract to make a will giving one-fifth of the promisor's estate in consideration of the promisee's personal services is a contract, not a will. It is supported by consideration. It is irrevocable, except by mutual consent. Liability arises from its breach. A will is revocable, ambulatory, the antithesis of a contract in fundamental respects. 'If the contract is thought of as a contract to pass property at death, and the will thought of as a vehicle for passing the property, much of the confusion and conflicts would disappear. The contract, not the will, gives the promisee a right to the property, and when litigation arises, it is the contract that must always be established. Once the contractual right is established the interests of the promisee are protected whether or not a will has been executed.' Sparks, Contracts to Make Wills (N.Y.U 1956), p. 112.

When Hunter died without a will Mrs. Cotnam's only remedy was by an action on the contract. The relief available depends upon principles of contract law, and the fact that the consideration moving from the promisor was the making of a will does not distinguish it from any other contract where a promisee has to do something or give something. The substance of the Hunter-Cotman transaction was Hunter's agreement to give one-fifth of his property to Mrs. Cotnam on his death for her services. The Alabama Supreme Court enforced a contract, not a non-existent will.

The pleadings in the Alabama proceedings show clearly that Mrs. Cotnam's claim was based on the theory of a contract for services. The original claim in the probate court of Mobile County stated: 'Estate of T. Shannon Hunter, deceased, In account with Ethel W. Cotnam. Amount owing and due to Ethel W. Cotnam under an agreement between T. Shannon Hundred and Ethel W. Cotnam, by which she was to receive and be paid a sum equal to one-fifth (1/5) of the value of his estate, which agreement has been fully performed on her part, and for services rendered—$175,000.00.' The amended claim before the Circuit Court, where the case was tried de novo, is to the same effect.[3] The Alabama Supreme Court held that 'agreements of this kind are binding. Such a right being contractual, is not affected by a will or its probate'. *Merchants National Bank of Mobile v. Cotnam, 1948, 250 Ala. 316, 34 So.2d 122, 126.*

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[3] 'Comes Ethel W. Cotnam and amends the claim heretofore filed in this Court against the Estate of T. Shannon Hunter, deceased, so that the same shall read as follows: 'Amount owing and due by the Estate of T. Shannon Hunter to Ethel W. Cotnam, under a verbal agreement between her and T. Shannon Hunter made during the month of June, 1940, by which she agreed to give up her position and case working at the Saenger Theatre in the City of Mobile, where she was then and there gainfully employed, and to move from Springhill, Alabama, into an apartment or residence in the city of Mobile, and thereafter to render services and attention to the said T. Shannon Hunter during his remaining lifetime as an attendant or friend, in consideration of which the said T. Shannon Hunter agreed to make a will by the terms of which she would at his death, be bequeathed by him or receive from his Estate thereunder a sum equal to one-fifth (1/5) of the value of the Estate of the said T. Shannon Hunter, deceased, at the time of his death, which agreement and services were duly performed on her part, and which agreement was not performed on the part of the said T. Shannon Hunter – $175,000.00."

The legal proceedings against Hunter's estate were instituted under Title 61, section 216 of the Code of Alabama 1940.[4] A proceeding under this section 'is not intended to lead to a personal judgment, but is in the nature of a declaratory judgment to determine the validity of the claim which has been filed against the estate'. Merchants National Bank v. Cotnam. The Alabama court pointed out however that the parties and the court tried the case in the circuit court on appeal, 'as if it were a

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[4] 61 Code of Alabama (1940):

'§216. When claim disputed either party may demand hearing. — The personal representative of the estate of a decedent may give notice in writing to the claimant, or anyone having a beneficial interest in a claim against the estate, that such claim is disputed in whole or in part, if in part specifying the part disputed; thereupon the judge of the court having jurisdiction of the administration of the estate shall, on written application of either the personal representative or the claimant, hear and pass on the validity of such claim, or part thereof, first giving ten days' notice of such hearing to the interested parties. If the claimant in such proceeding shall fail to recover upon the disputed part of such claim, he shall be taxed with the costs thereof. This section shall not apply to claims against estates declared insolvent. If the judgment on any such claim is rendered by a probate court, either party may within thirty days after rendition of such judgment appeal to the circuit court of the county in which the administration of said estate is pending, and the trial of the validity of said claim in said circuit court shall be de novo and upon demand, of either party, filed in the circuit court within thirty days from the taking of said appeal shall be tried by a jury. If the administration of an estate in which a claim is disputed is pending in the circuit court, or court of similar jurisdiction, the trial of the validity of said claim shall be by jury upon demand of either party filed within thirty days after written notice that the claim is disputed. In any event either party may appeal to the supreme court of court of appeals, as the case may be, from the judgment of the circuit court or court of similar jurisdiction, such appeal to be taken within thirty days, and as other appeals are taken.'

common law action begun as such. To that extent it did not conform to section 216' of Title 61 of the Alabama Code. The Supreme Court of Alabama said that in addition to relief under the Code, '(a) claim for damages for the breach of a contract is also an alternative remedy available to her, and an account for services rendered on a quantum meruit. We see no reason why the parties cannot with the consent of the court convert it into such an action and have a personal judgment accordingly rendered'.

In *Blease v. Commissioner, 1929, 16 B.T.A. 972,* on similar facts, the court held that money recovered in a judgment against an estate was taxable income, not a bequest. 'Complainant (the taxpayer) proceeded at law and sought and recovered only a money judgment which gave to her a claim as we believe, superior to that of any legatee or devisee. We are clearly of the opinion that complainant participated in the estate of testator as a creditor and not as a legatee and that the amount recovered by her was compensation for services rendered.'

In *Davies v. Commissioner, 1954, 23 T.C. 524,* the taxpayer was a nurse, secretary, and bookkeeper for a doctor who had promised to provide for her in his will. He died intestate. She filed a claim in the probate court. When the jury could not reach a verdict, the claim was compromised for $8,500. The court held: 'Actually, Gertrude did not receive the $8,500 or any part of it by bequest, devise, or inheritance from Tivnen. She did not receive anything by inheritance from him because she was not related to him in any way and claimed no relationship, and she did not receive anything by bequest or devise because he left no will.' The reasoning applies with equal vigor here.

The taxpayer's confidence in *Cox v. Hutto, 1927, 216 Ala. 232, 113 So. 40, 42,* is misplaced. The court did say:

The bill presents a proper case for relief in the nature of specific performance. The heirs succeed to and hold the legal title to the lands in trust for the complainants. Complainants are entitled to have this title divested and vested in themselves and their status as devisees and legatees adjudicated as if a will had been made according to contract. The contract having operation as a will, passing all the property owned at the time of decedent's death, the general description of the personal estate is sufficient. No inventory was required.'

The court reached its decision, however, by applying ordinary principles of contract; for example:

The instrument is a contract to execute a will, operative upon the property owned at the death of testators, rather than a deed to specific property. It is supported by a valuable consideration. In no event could that statute be construed to impair the obligation of contracts existing at the time it became effective.'

In Cox v. Hutto, as in similar cases of suits for specific performance, the court enforced the contract. When the promisor fails to perform, equity uses a constructive trust to accomplish performances of the contract; the title a personal representative takes from the intestate promisor is subject to the constructive trust. But only in a rhetorical sense can it be said that the successful litigant in a suit to enforce a contract is the legatee of a will that was never written.

Section 22(a) adds salt to the taxpayer's wound. It provides that gross income shall include 'compensation for personal service, in whatever form paid'. Labelling something a bequest will not result in a tax exemption.

Bank of New York v. Helvering, 2 Cir., 1943, 132 F.2d 773.

There is no difference between a contract to compensate for one's personal service in the form of a bequest, and one in which the contractor agrees to pay for the services during his life. *Ex parte Simons, 1918, 247 U.S. 231, 38 S.Ct. 497, 62 L.Ed. 1094.* The law does not stop at the form of a transaction, it goes to its substance. Thus, income received is taxable or nontaxable according to what it represents. *Hort v. Commissioner, 1941, 313 U.S. 28, 61* S.Ct. 757, *85 L.Ed. 1168.* Here the amount of the judgment represented payment under a contract for personal services.

As we read the law, property is acquired by bequest, within the meaning of the Code, only when actual service is not required as a condition of payment of the legacy. *United States v. Merriam, 1923, 268 U.S. 179, 44 S.Ct. 69, 70, 68 L.Ed. 240.* The Merriam case involved the taxability of bequests to executors.

The principle set out is equally applicable here:

'(The term) does include the bequest here under consideration since, as we shall presently show, actual service as a condition of payment is not required.

'The distinction to be drawn is between compensation fixed by will for services to be rendered by the executor and a legacy to one upon the implied condition that he shall (merely) clothe himself with the character of executor. In the former case he must perform the service to earn the compensation.

'The word 'bequest' having the judicially settled meaning which we have stated, we must presume it was used in that sense by Congress.'

The rule of the Merriam case is well established. *Bank of New York v. Helvering, 2 Cir. 1943, 132 F.2d 773; Rose v. Grant, 5 Cir., 1930, 39 F.2d 338.* 'If services have been performed by the recipients it may well be said the presumption is that the payment is for the services and not a gift.' *Wallace v. Commissioner, 5 Cir., 1955, 219 F.2d 855, 857.*

Ethel Cotnam had to carry out her part of the contract to get paid. She had to render service to Hunter. Payment was conditioned on this. She could not acquire the $120,000 by 'bequest' as the term is used in the Code. She could and did acquire it because her contract gave it to her for personal services rendered. Accordingly, the judgment in Mrs. Cotnam's favor was correctly taxed as income for personal service 'in whatever form paid'.

II.

A majority of the Court, Judges Rives and Brown, hold that the $50,365.83 paid Mrs. Cotnam's attorneys should not be included in her gross income. This sum was income to the attorneys but not to Mrs. Cotnam.

The Alabama Code provides: 'The attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amont due thereon to them'.[5]

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[5] 46 Code of Alabama (1940):

'§64. Line of attorneys at law./

'2. Upon suits, judgments, and decrees for money, they shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amont due thereon to them.'

In construing this statute the Alabama courts have given full effect to the statute. Attorneys have the same rights as their clients. *Western Railway Co. v. Foshee, 1913, 183 Ala. 182, 62 So. 500; Denson v. Alabama Fuel & Iron Co., 1916, 198 Ala. 383, 73 So. 525.* Under Alabama law, therefore, Mrs. Cotnam could never have received the $50,365.83, even if she had settled the case directly with the Bank.

In *United States Fidelity & Guaranty Co. v. Levy, 5 Cir., 1935, 77 F.2d 972, 975,* Judge Hutcheson, speaking for the Court, held that the Alabama statute creates a charge 'in the nature of an equitable assignment (or) equitable lien' in the cause of action. An attorney 'holding such an interest has an equity in the cause of action and the recovery under it prior to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.'

The facts in this unusual case, taken with the Alabama statute, put the taxpayer in a position where she did not realize income as to her attorneys' interests of 40% in her cause of action and judgment.

Judges RIVES and BROWN add to the foregoing, the following:

When Mr. Hunter died without a will and his Administrator declined to recognize Mrs. Cotnam's claim that he had made a verbal contract to leave her one fifth of his estate, she was a long way from having the equivalent of cash. Her claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. Accordingly she, in effect, assigned to her

attorneys forty per cent of the claim in order that she might collect the remaining sixty percent. That was not the assignment of income of Mrs. Cotnam within the doctrine of *Lucas v. Earl, 1930, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731.* Mrs. Cotnam's services had been performed before Mr. Hunter's death, and for those services she had earned a claim which was worthless without the aid of skillful attorneys. At the time that she entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder.

By such limited use she has not 'fully enjoyed the benefit of his (her) economic gain represented by his (her) right to receive income' within the doctrine of *Helvering v. Horst, 1940, 311 U.S. 112, 61 S.Ct. 144, 147, 85 L.Ed. 75,* and *Helvering v. Eubank, 1940, 311 U.S. 122, 61 S.Ct. 149, 85 L.Ed. 81.* That doctrine can have no just or realistic application to a case like this, where the only economic benefit to the taxpayer was as an aid to the collection of a part of an otherwise worthless claim.

The services of her attorneys resulted in converting that claim into a judgment and the collection of the judgment. The amount of the contingent fee was earned, and well earned, by the attorneys.

True, in a remote rather than a proximate sense, the entire amount of the judgment had also been earned by Mrs. Cotnam, but she could never have collected anything or have enjoyed any economic benefit unless she had employed attorneys, and to do so, she had to part with forty per cent of her claim long before the realization of any income from it. The only income, the only real economic benefit, which Mrs. Cotnam ever received was the

$75,254.17 which she collected. (In our opinion, it is as illegal as it is unjust to tax her on the remaining $50,365.83 which did not pass through her hands and of which she never had control.) In a realistic sense the remaining $50,365.83 was income of the attorneys, not of Mrs. Cotnam.

The Commissioner makes a further argument in brief:

'Moreover, payment of the attorneys' fees was a legal obligation taxpayer herself had incurred. Regardless of the mechanics of their payment, the discharge of that legal obligation out of a judgment based on services she had performed was 'equivalent to receipt' by taxpayer of the amount of the attorneys' fees. Old Colony *Trust Co. v. Commissioner, 279 U.D. 716, 729 (49 S.Ct 499, 73 L.Ed. 918).*'

That argument seems to us to be based on the false premise that Mrs. Cotnam obligated herself to pay the attorneys' fee. She did not. Their fee was contingent upon success, and was fully paid by the assignment of a portion of a doubtful claim. Mrs. Cotnam's tree (*Lucas v. Earl, supra)* had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit.

Accordingly, the attorneys' fee of $50,365.83 should not have been included in the taxpayer's gross income.

The judgment is affirmed in part and reversed in part.

DISSENT BY:
WISDOM

DISSENT:

WISDOM, Circuit Judge (dissenting).

The fates and the tax collector, a formidable combination, have cut so deeply into the award for Mrs. Cotnam's services that it is with some regret I feel constrained to dissent from the holding that the amount paid as attorneys' fees is excluded from the taxpayer's gross income.

Mrs. Cotnam sued the Hunter Estate and recovered on the theory that she had a contract for compensation for services rendered. Thus, at the time of the assignment to the attorneys all of her services had been rendered and all of the income earned. It seems to me that this case is governed by the principles set forth in *Helvering v. Horst, 1940, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75,* and *Helvering v. Eubank, 1940, 311 U.S. 122, 61 S.Ct. 149, 85 L.Ed. 81.* In Horst, the donor transferred interest coupons detached from bonds delivered to the donee and later paid at maturity. The court held that whether the assignment preceded the rendition of services, as in *Lucas v. Earl, 1930, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731,* or came after, 'the exercise of the power of disposition of the interest or compensation is the enjoyment by the donor of income derived from them'. *(311 U.S. 112, 61 S.Ct. 148).* Mr. Justice Stone, for the majority stated:

'the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. (Taxation) may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can

escape all tax by giving away his right to income in advance of payment. Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary The import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew.'

This case is stronger than Horst or Eubank, since Mrs. Cotnam assigned the right to income already earned. She controlled the disposition of the entire amount and diverted part of the payment from herself to the attorneys. By virtue of the assignment Mrs. Cotnam enjoyed the economic benefit of being able to fight her case through the course and discharged her obligation to her attorneys (in itself equivalent to receipt of income, under *Old Colony Trust Co. v. Commissioner, 1929, 279 U.S. 716, 49 S.Ct 499, 73 L.Ed. 918.)*

The taxpayer contends that the deduction for attorneys' fees should have been prorated over the four and a half year period in which the income was prorated. Section 107 permits the carry bank computation of gross income, not net income.[1] It refers specifically to 'compensation for personal services'. Section 107 has no mention of net compensation and no provision for proration of expenses incurred in collecting the compensation. Attorneys' fees therefore may be deducted only in the year

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[1] Sec. 107(a): 'Personal services. If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attibutable to such part had it been included in the gross income of such individual ratability over that part of the period which precedes the date of such receipt or accrual.' *26 U.S.C.A. 1952*, ed., Section 22.

the fees were paid, 1954. *Smith v. Commissioner, 1951, 17 T.C. 135,* rev'd on other grounds, 2 Cir., 1952, *203 F.2d 310.*

APPENDIX D

RECOMMENDED FOR FULL-TEXT PUBLICATION
Pursuant to Sixth Circuit Rule 206

ELECTRONIC CITATION: 2000 FED App. 0020P (6th Cir.)
File Name: 00a0020p.06

UNITED STATES COURT OF APPEALS
For The Sixth Circuit

No. 98-2437

ESTATE OF ARTHUR L. CLARKS,
by and through its duly appointed
Independent Personal Representative,
MARY J. BRISCO-WHITTER, also known as
MARY J. CLARKS,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Eastern District of Michigan at Ann Arbor.
No. 96-60446—George C. Steeh, District Judge.

Argued: December 16, 1999

Decided and Filed: January 13, 2000

Before: MERRITT and SILER, Circuit Judges;
BECKWITH, District Judge.

OPINION

MERRITT, Circuit Judge. The question on appeal concerns the federal income taxation of clients on contingent fees paid to lawyers. In June 1988, a jury awarded Arthur Clarks $5,600,000 in personal injury damages against K-Mart for head injuries sustained while unloading his truck. In 1991, K-Mart paid $11,307,875.55 in total satisfaction of the judgment, $5,600,000 for the award and $5,707,837.55 in interest. From that amount, the judgment debtor paid Clarks' lawyer under a one-third, contingent fee contract $1,865,156.54 based on the original award and $1,901,314.67 based on the interest for a total fee of $3,766,471.21. After Clarks died in March 1992, his estate filed his 1040 for the 1991 tax year. Recovery for personal injury is ordinarily not taxable under §104(a)(2) of the Internal Revenue code, but the interest on the award is. The only question before us on appeal is whether the $1,901,314.67 in interest paid to the lawyer must be included as gross income of the decedent under §61(a) of the tax code ("gross income means all income from whatever source derived"), as well as included in the lawyer's income. The estate did not include the interest portion of the attorney fee award as interest income because the estate did not receive any of the money. It was paid directly to the lawyer.

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*The Honorable Sandra S. Beckwith, United States District Judge for the Southern District of Ohio, sitting by designation.

In November 1992, the IRS conducted an audit of Clarks' 1991 tax return. It notified the decedent's estate that it had a tax deficiency of $254,298 because the estate improperly failed to include as income the interest paid to the lawyer on the contingent fee contract and because the interest should be deducted as a miscellaneous itemized deduction subject to a two percent of adjusted gross income limitation. *See* 26 U.S.C. §§ 61(a), 67(a). As a result of the two percent floor on itemized deductions under Code §67(a) ("miscellaneous itemized deductions... allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income") and the alternative minimum tax applicable to interest income under Code §55, the estate had to pay the additional $254,298 in taxes owed, plus interest. The estate filed an action in federal district court seeking a refund of all tax and interest paid on the interest portion of the damage award for the 1991 tax year. At no time has the non-interest portion of the award ($5,600,000) been at issue since it is clearly not taxable as income pursuant to 26 U.S.C. §104(a)(2). Neither is there an issue before us concerning the taxation of the income in the hands of the lawyer. Both parties filed cross motions for summary judgment. The district court granted summary judgment for the government and against the taxpayer. We do not agree.

* * *

There is a conflict in the Circuits on the issue of whether the interest portion of an attorney's contingency fee should be included in the client's income under Code §61(a), even though the lawyer received and paid taxes on all of the money and the client received none of the money. Compare *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959), with *Baylin v. United States*, 43 F.3d 1451

(Fed. Cir. 1995). *Cotnam* was the first to address the issue. In a 2-1 decision, the old Fifth Circuit held that the amount of the contingent fee paid out of the judgment to plaintiff's attorneys was not income to plaintiff. *See Cotnam,* 263 F.2d at 126. Under Alabama state law, a contingency fee contract operates as a lien on the recovery. The Alabama code provided at the time that "attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." 46 ALA. CODE §64 (1940). The *Cotnam* court found that this lien operated as a transfer of part of plaintiff's claim and that any recovery as to that portion of the claim would not be regarded as gross income to the plaintiff taxpayer. *Cotnam,* 263 F.2d at 125. The court concluded that the amount of the contingent fee was earned by the attorney, not the taxpayer, whose only real economic benefit from the claim amounted to a percent of the total judgment he received due to the lawyer's efforts. *See id.* at 126.

The common law lien in this case under Michigan law operates in more or less the same way as the Alabama lien in *Cotnam.* RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY §116, at 559 (2d ed. 1955), describes a common law attorney's lien as follows:

> According to Mr. Justice Earl, of the New York Court of Appeals, "the lien, as thus established, is not strictly like any other lien known to the law, because it may exist although the attorney has not and cannot, in any proper senses, have possession of the judgment recovered. It is a peculiar lien, to be enforced by peculiar methods. It was a device invented by the courts for the protection of attorneys

> against the knavery of their clients, by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained. The lien was never enforced like other liens. If the fund recovered was in possession or under the control of the court, it would not allow the client to obtain it until he had paid his attorney, and in administering the fund it would see that the attorney was protected. If the thing recovered was in a judgment, and notice of the would see that the attorney was protected. If the thing recovered was in a judgment, and notice of the attorney's claim had been given, the court would not allow the judgment to be paid to the prejudice of the attorney." [Quoting *Goodrich v. McDonald*, 112 N.Y. 157, 19 N.E. 649 (1889)].

Although the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment. Michigan law is not inconsistent with this view of the attorney's lien, *Dreiband v. Candler*, 166 Mich. 49, 131 N.W. 129 (1911),–holding that "the [contingent fee] agreement amounts to an assignment of a portion of the judgment sought to be recovered." *Id.* at 51, 131 N.W. at 129.

In a more recent decision, the Federal Circuit reached the opposite result. *Baylin* held that the contingent fee portion of settlement from a condemnation proceeding paid directly to the lawyer was income to the plaintiff taxpayer. *Baylin*, 43 F.3d at 1455. *Baylin* mentioned the Supreme Court's liberal interpretation of "gross income" and then found that although the plaintiff never had actual possession of the funds paid to the lawyer, plaintiff received the benefit of those funds in that they dis-

charged an obligation of the plaintiff owed to the lawyer as a result of his work. *See Baylin*, 43 F.3d at 1454.

Baylin relied on two early Supreme Court tax cases interpreting §61(a), *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940). In *Lucas*, taxpayer Earl assigned one half his right to salary and fees earned by him to his wife in order to avoid paying taxes on the whole, *Lucas*, 281 U.S. at 113-14. In *Horst*, taxpayer Horst, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who later that year collected interest on them. *Horst*, 311 U.S. at 114. Even though the proceeds were originally vested in the donors, since Lucas himself never received the income apportioned to his wife and Horst never actually received any interest from the coupons, both claimed that they should not have to include the assignment as income. In rejecting the taxpayer's argument, the Supreme Court concluded that the "dominant purpose of the revenues laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." *Horst*, 311 U.S. at 119. In *Lucas* and *Horst*, each taxpayer earned and created the right to receive and enjoy the benefit of the income before any assignment.

We follow *Cotnam* concluding that the majority in *Cotnam* correctly distinguished *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940). In the instant case, as in *Cotnam*, the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. The only economic benefit Clarks could derive from his claim against the defendant in state court was to use the contingent part

of it to help him collect the remainder. Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds. Just as in *Cotnam*, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.

In *Lucas* and *Horst*, the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor. It was a gift of accrued income to a family member. The assignor's purpose was to split income with a family member and avoid the donor's higher rate under the progressive income tax. The income had a tangible known value to the assignor. The assignee performed no services in order to receive the income. There was no business purpose other than tax avoidance. There was no joint venture to reduce a speculative claim to money. Not so in this case. Here there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury. Clarks, as an assignor, had no predetermined interest in any res before entering a contingency fee arrangement with his attorney, unlike the taxpayer plaintiffs in *Lucas* and *Horst*. There was no purpose to shift tax liability among members of a family.

In *Lucas* and *Horst*, the assignees were the object of gifts and not subject to income taxation themselves if the income was taxed to their assignor or donor. The IRS chose to tax the assignors, not both the donors and donees. By having the income taxed to the donor, the donee escapes income taxation. Not so here. Here the

lawyer is taxed on the full amount of the payment. Under the government's theory both the lawyer and the client are taxable.

The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant. *See Wodehouse v. Comm'r,* 177 F.2d 881, 884 (2d Cir. 1949); Surrey, "Assignments of Income and Related Devices, Choice of the Taxable Person," 33 COL. L. REV. 791 (1933).

For the forgoing reasons, we reverse the judgment of the district court and grant plaintiff estate's motion for summary judgment.

APPENDIX E

[Filed APR 27 2000]

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 98-7026

D.C. Docket No. 4077-96

WILLIE MAE BARLOW DAVIS,

Petitioner-Appellee,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from a Decision of the United States Tax Court

(April 27, 2000)

Before ANDERSON, Chief Judge, COX and HULL, Circuit Judges.

PER CURIAM:

This case presents the issue of whether the portion of a judgment paid directly to the taxpayer's attorneys pursuant to a contingency fee arrangement is taxable as income to the taxpayer.

I. FACTS AND PROCEEDINGS BELOW

In 1992, Willie Mae Davis prevailed in a suit against a mortgage company and won a $6,151,000 judgment, of which six million dollars was punitive damages. She had entered into a contingency fee arrangement with her attorneys in 1989 and upon receiving the judgment, they retained $3,111,809 and she received $3,039,191. Initially, Ms. Davis did not report any of the award as income in 1992 and upon audit, the Internal Revenue Service ("IRS") determined that the entire six million dollar punitive damages award should be included as income.[1] The IRS allowed Ms. Davis a deduction for attorneys' fees and costs in the amount of $3,069,250 and determined that Ms. Davis had a deficiency of $1,441,736.

Ms. Davis petitioned the Tax Court for a redetermination of the deficiency. The Tax Court found that although the punitive damages were otherwise taxable as income, the amount paid to her attorneys was not taxable income under *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959).[2] Thus the Tax Court determined that Ms. Davis's deficiency was $919,772.[3] The IRS appeals.

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[1] The compensatory damages of $151,000 were excludable because they were damages received on account of personal injuries. *See O'Gilvie v. United States*, 519 U.S. 79, 117 S.Ct. 452 (1996).

[2] In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), this Court adopted as binding precedent all of the decisions of the former Fifth Circuit handed down prior to the close of business on September 30, 1981.

[3] The deduction for attorneys' fees and costs which the IRS allowed was less favorable to the taxpayer than the exclusion-from-income approach adopted by the Tax Court because the operation of technical tax rules such as the alternative minimum tax.

II. STANDARD OF REVIEW

We review de novo the tax court's conclusions of law and findings of fact for clear error. *See Sleiman v. Commissioner*, 187 F.3d 1352, 1358 (11th Cir. 1999).

III. DISCUSSION

This Court has previously addressed the issue of whether a taxpayer is taxed on the portion of a judgment paid to the attorneys under a contingency fee arrangement in Alabama, and in light of the attorneys' lien statute in Alabama, Ala. Code §34-3-61 (1997). In *Cotnam v. Commissioner*, the former Fifth Circuit found that a woman, who obtained a judgment on her oral contract with a man to care for him in return for a fifth of his estate, was not required to include as income the portion of the award paid to her attorneys for their work in enforcing that contract. Because *Cotnam* is squarely on point and controlling, as the IRS acknowledges, we affirm the Tax Court on this issue.[4]

Next, the IRS argues, in the alternative, that Ms. Davis made a taxable disposition of her property in 1989 when she entered into the contingency fee arrangement. Reasoning that the court's interpretation of the Alabama attorneys' lien statute in *Cotnam* gave an ownership interest in the claim to Ms. David's attorneys, the IRS argues that by entering into the fee arrangement agreement, Ms. Davis in essence sold part of her cause of action in 1989. Realizing that that taxable event in 1989

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[4]The IRS's primary argument is that *Cotnam* was wrongly decided and should be overruled. We need not address this argument because this panel is bound by *Cotnam*, which can be overruled only by the en banc court. *See United States v. Woodard*, 938 F.2d 1255, 1258 (11th Cir. 1991).

would be time-barred, the IRS suggests that the value of the cause of action and the value of the attorneys' services were unascertainable in 1989, and thus that the taxable event should be deferred pursuant to the open transaction doctrine. The open transaction doctrine, introduced in *Burnet v. Logan*, 283 U.S. 404, 51 S.Ct. 550 (1931), permits a delay in the assessment of the value of the property until the sum is made certain. Thus, under this logic, the IRS argues that Ms. Davis's taxes should not be assessed until 1992 when she received her judgment, and the value of the attorneys' services and her claim became apparent.

The open transaction doctrine is only applicable when it is not possible to discern the value of either of the assets exchanged. Under *United States v. Davis*, 370 U.S. 156, 82 S.Ct. 1190 (1962), when only one of the assets has an unascertainable value, it is presumed to be of the same worth as the property for which it was exchanged. The IRS concedes that it bore the burden of showing that the open transaction doctrine applied and that the values of the properties exchanged were not ascertainable at the time of the exchange. Because the IRS provided no proof that the values of either the cause of action or the attorneys' services were unascertainable, it has failed to establish that the open transaction doctrine should apply.[5]

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[5]In light of this disposition, we of course need not decide whether there was a taxable event in 1989.

Because we find that *Cotnam v. Commissioner* is controlling and that the IRS failed to bear its burden of proof on its open transaction argument, we affirm the decision of the Tax Court.

AFFIRMED.

[Certificate of Service Omitted In Printing]

APPENDIX F

LEXSEE 220 f3d 353

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 99-60437

SUDHIR P. SRIVASTAVA and
ELIZABETH S. PASCUAL,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

220F.3d 353; 2000 U.S. App. LEXIS 17309;
2000-2 U.S. Tax Cas. (CCH) P50,597

July 19, 2000, Decided

SUBSEQUENT HISTORY:
As Revised July 21, 2000.

PRIOR HISTORY:
Appeal from the United States Tax Court. 26605-95.

DISPOSITION:
REVERSED the Tax Court's decision to tax contingent fees and REMANDED for a recalculation of the defi-

ciency and any appropriate penalties, and AFFIRMED the Tax Court's allocation of the settlement proceeds among actual damages, interest, and punitive damages.

COUNSEL:
For SUDHIR P SRIVASTAVA, ELIZABETH S PASCUAL, Petitioners - Appellants: Michael Dale Cropper, Midland, TX.

For COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee: Richard Bradshaw Farber, Kenneth W Rosenberg, US Department of Justice, Washington, DC.

For TEXAS TRIAL LAWYERS ASSOCIATION, Amicus Curiae: Henry Binder, Porter & Hedges, Houston, TX.

JUDGES:
Before POLITZ, SMITH, and DENNIS, Circuit Judges.

OPINIONBY:
JERRY E. SMITH

OPINION:

JERRY E. SMITH, Circuit Judge:

This challenge to a notice of deficiency requires us to determine whether the portion of a judgment or settlement payable to a taxpayer's attorney pursuant to a contingent fee agreement governed by Texas law constitutes gross income under §*61 of the Internal Revenue Code, 26 U.S.C.* §*61*. Following *Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959)*, which excluded from gross income contingent fees governed by Alabama law, we conclude that contingent fees paid according to Texas law are also excludable.

We therefore reverse the Tax Court's contrary conclusion and remand for a recalculation of the deficiency and a new determination of the propriety and size of any penalties. We find no clear error in the Tax Court's allocation of the litigation settlement between non-taxable items (that is, actual damages) and taxable items (that is, interest and punitive damages) and thus affirm on that issue.

I.

Petitioner Sudhir Srivastava, like his wife, petitioner Elizabeth S. Pascual, is a medical doctor. The KENS-TV television station aired a series of investigative reports accusing Srivastava of delivering poor quality medical care and committing acts that would have been criminal under Texas law. These reports destroyed Srivastava's practice and caused substantial financial and emotional harm to him and his family.

Srivastava sued the station and its parent corporations (collectively, the "station") in state court for defamation and related claims. The jury awarded $11.5 million in actual damages, $17.5 million in punitive damages, and pre- and post-judgment interest. The station appealed, then it and its insurance carriers settled for $8.5 million.

The station was covered by a number of policies that were triggered at different tiers of liability. Two of the insurers were insolvent, however, and thus afforded no protection. The station's first $2 million of liability was covered by Continental Casualty and American Casualty. Liability between $2 million and $7 million was supposed to be covered by Mission Insurance Company, but it was insolvent. Likewise, the insurer for liability between $7 and $12 million, Western Employer's Casualty, was functionally insolvent. Columbia Casualty Com-

pany and Hudson Insurance Company covered liability for the $12 million to $22 million range, and Federal Insurance Company insured the station for liability in excess of $22 million. The station thus was ineffectively covered for liability in the $2 to $7 million range, so, to activate the higher levels of coverage in the absence of a negotiated settlement, it would be forced to take responsibility for that liability range.

The parties reached a partial settlement agreement, releasing the station from liability in exchange for $8.5 million, to be paid by the station and some of the insurers. The agreement was structured to discharge diverse portions of the judgment separately, in accordance with the stations' various tiers of coverage. The first $7 million of the award was jointly discharged by Continental Casualty, contributing $2.1 million, and the station, contributing $1 million. The station additionally would discharge the $7 million to $12 million portion of the judgment, and the award of post-judgment interest, by paying $2.4 million. Columbia Casualty and Hudson Insurance agreed to pay $3 million to settle the $12 million to $22 million portion of the judgment. Any remaining amounts would be pursued against Federal Insurance Company exclusively.[1]

II.

A.

Petitioners received their settlement proceeds in 1991 but reported no gross income therefrom, reasoning that

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[1] Federal Insurance Company, the station's insurer for liabilities in excess of $22 million, denied coverage on the ground that the station had not suffered liability in excess of $22 million. This court upheld that decision. *See Federal Ins. Co. v. Srivastava, 2 F.3d 98 (5th Cir. 1993).*

the judgment constituted recovery exclusively for non-taxable actual damages.[2] To recover the tax on the portion of the settlement representing (according to the Commissioner's determinations) interest and punitive damages, both of which are taxable,[3] the Commissioner of Internal Revenue issued a notice of deficiency of $1,188,920 for tax year 1991 and $33,037 for tax year 1992.[4]

The Settlement agreement did not separate the proceeds into the various categories of recovery for (non-taxable) actual damages and (taxable) interest and punitive damages, nor did the parties discuss any method of allocation. The Commissioner thus estimated the amounts attributable to interest and punitive damages by applying to the settlement agreement the proportions of the original jury verdict represented by interest and punitive damages. The Commissioner also assessed penalties of $237,784 for 1991 and $6,607 for 1992.

B.

The petitioners challenged the deficiency notice in the Tax Court, which rejected their argument that the portion of the settlement payable to their attorneys under

[2] For the law governing the taxable years in question, *see 26 U.S.C.* §*104*(a)(2) (West 1988) (excluding from gross income the "amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness").

[3] *See 26 U.S.C.* §*61*(a)(4) (including interest within gross income); *O'Gilvie v. United States, 519 U.S. 79, 136 L.Ed.2d 454, 117 S.Ct. 452 (1996)* (holding that punitive damages are not awarded "on account of personal injuries or sickness" pursuant to *26 U.S.C.* §*104*(a)(2) and therefore constitute gross income).

[4] The 1992 deficiency represents the elimination of a net operating loss carryover attributable to the settlement proceeds received in 1991.

the contingent fee agreement did not constitute gross income. The Tax Court also rejected their claim that the settlement award represented exclusively actual damages.

Rather than examining the settlement award in its entirety, and then dividing it among actual damages, interest, and punitive damages, based on the proportions found in the original jury verdict (as the Commissioner had done), the Tax Court first broke the settlement down by the various tiers established by the settlement agreement, then matched each tier to its corresponding portion of the jury award. That is, the portion of the settlement discharging the first $11.5 million, which the jury had awarded for actual damages, was attributed to actual damages. In other words, the amounts paid by Continental Casualty and the station were left untaxed.

The Tax Court attributed the balance of the station's payment to interest, a taxable item. The payments from Columbia Casualty and Hudson Insurance Company, representing the remaining interest and punitive damages, was made subject to tax.

The Tax Court reduced the deficiencies and penalties accordingly. It disallowed the assessment of penalties with respect to the amount of deficiency attributable to punitive damages, holding that the petitioners, though wrong in doing so, had reasonable cause for not reporting taxable income arising from the portion of the settlement representing punitive damages. [5] The Tax Court left intact the penalties with respect to interest.

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[5] It was not until *O'Gilvie* that the Court made plain that punitive damages were not excludable under *26 U.S.C.* §*104*-(a)(2) and therefore were subject to tax. *See Robinson v. Com-*

[footnote continued]

III.

The petitioners contend that the portion of a judgment or litigation settlement payable to their attorney pursuant to a contingent fee agreement governed by Texas law is not gross income. This is a question of substantial importance, for although attorney fee expenses, if included within gross income, may be deductible, [6] various limitations may operate to reduce the effectiveness of such deductions.[7]

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missioner, 102 T.C. 116 (1994) (holding that punitive damages are excludable from gross income under *26 U.S.C.* §*104*(a)(2)); *Threlkeld v. Commissioner, 87 T.C. 1294 (1986)* (same); *Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983)* (same).

[6] Attorney's fees are potentially deductible either as an "ordinary and necessary expense [ ] paid or incurred . . . in carrying on any trade or business," *26 U.S.C.* §*162*(a), or as an "ordinary and necessary expense [ ] paid or incurred . . . for the production or collection of income," *26 U.S.C.* §*212*(1). Determining which deduction to apply requires the use of the "origin of the claim" test. *See United States v. Gilmore, 372 U.S. 39, 49, 9 L.Ed.2d 570, 83 S.Ct. 623 (1963)* (observing that "the origin and character of the claim with respect to which an expense was incurred . . . is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether [and how] it is deductible"). Because we conclude that Srivastava's contingent fees are excludable from gross income, we have no occasion to decide which basis for a deduction would have applied.

[7] For example, "the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." *26 U.S.C.* §*67*(a). *Section 68 of the Internal Revenue Code* limits the total amount of itemized deductions allowed. *See 26 U.S.C.* §*68*. Finally, the alternative minimum tax also may operate to reduce the value of a deduction. *See 26 U.S.C.* §§*55*(b)(2), 56(b)(1)(A)(i). *See also Barlow-Davis v. Commissioner, 210 F.3d 1346, 1347 n.3 (11th Cir. 2000)* ("The deduction for attorneys' fees and costs which the IRS allowed was less favorable to the taxpayer than the exclusion-from-income ap-

[footnote continued]

Were we ruling on a *tabula rasa*, we might be inclined to include contingent fees in gross income. Principles of tax neutrality, if nothing else, dictate that result, for when a taxpayer recovers from a favorable judgment or litigation settlement, and compensates his attorney on a *non-contingent* basis, the full amount of the recovery may be treated as gross income (as petitioners acknowledged during oral argument). There is no apparent reason to treat *contingent* fees differently or to believe that Congress intended to subsidize contingent fee agreements in such a fashion.

In *Cotnam*, however, this court excluded contingent fees governed by Alabama law from the client's gross income. Because *Cotnam* is substantially indistinguishable from this case, we reverse the Tax Court and decide that contingent fees governed by Texas law are also excludable. In doing so, we acknowledge the circuit split on this issue, with the Sixth Circuit recently adopting *Cotnam's* reasoning,[8] and the Third,[9] Ninth[10] and

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proach adopted by the Tax Court because of the operation of technical tax rules such as the alternative minimum tax."); *Kenseth v. Commissioner, 2000 U.S. Tax Ct. LEXIS 32*, at 18, *114 T.C. No. 26 (2000)* ("This controversy is driven by the substantial difference in the amount of tax burden that may result from the parties' approaches. The difference, of course, is a consequence of the plain language of sections 56, 67, and 68, so the characterization of the attorney's fees as excludable or deductible becomes critical."). (Footnote omitted.)

[8] *See Estate of Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2000)* ("We follow *Cotnam* concluding that the majority in *Cotnam* correctly distinguished *Lucas v. Earl*").

[9] *See O'Brien v. Commissioner, 38 T.C. 707, 712 (1962), aff'd, 319 F.2d 532 (3rd Cir. 1963)* (holding that contingent attorney fees are "gross income to [taxpayer] under the familiar principles of *Lucas v. Earl*").

[10] *See Coady v. Commissioner, 213 F.3d 1187, ___, 2000 U.S. App. LEXIS 13692*, at 10 (9th Cir. June 14, 2000) ("We

[footnote continued]

Federal[11] Circuits including contingent fees in gross income. [12] We also acknowledge the Tax Court's objection to *Cotnam* [13] and note that, as it properly has observed, in cases ultimately appealable to this court, [14] the Tax Court is bound by our precedent. [15]

A.

Because the text of the Internal Revenue Code is of little help, [16] we turn to judicially-developed tax law

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are persuaded by . . . Judge Wisdom's dissent in *Cotnam*."); *Brewer v. Commissioner, 172 F.3d 875, 1999 U.S. App. LEXIS 3568,* at 3 (9th Cir. 1999), *aff'g without published opinion T.C. Memo. 1997-542* ("The fact that [the taxpayer] did not actually receive the gross payment and that the legal fees were paid directly to counsel does not alter the fact that Brewer received the benefit of the full settlement amount.").

[11] *See Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995)* (including contingent fees in gross income).

[12] The Eleventh Circuit is bound by holdings of the former Fifth Circuit. *See Davis, 210 F.3d at 1347 n.2.*

[13] *See Kenseth, 2000 U.S. Tax Ct. LEXIS 32,* at 21 ("The *Cotnam* holding with respect to the Alabama attorney lien statutes has been distinguished by this Court from cases interpreting the statutes of numerous other states. Significantly, this Court has, for nearly 40 years, not followed *Cotnam* . . . .") (collecting cases).

[14] *See 26 U.S.C.* §7482(a), (b).

[15] *See Golsen v. Commissioner, 54 T.C. 742, 756,57 (1970), aff'd, 445 F.2d 985* (10th Cir.) (noting that "better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone."); *Kenseth, 2000 U.S. Tax Ct. LEXIS 32,* at 29 ("With the exception of situations where . . . we feel compelled to follow the holding of a Court of Appeals, we have consistently held that attorney's fees are not subtracted from taxpayers' gross income to arrive at adjusted gross income").

[16] *See 26 U.S.C.* §61 (stating that "gross in come means all income from whatever source derived"); *James v. United*

[footnote continued]

principles, one of which is that any income or gain is not taxed until it is "realized." [17] In addition, to combat "anticipatory arrangements" designed to keep income from ever being realized by one person by the device of vesting, in advance of realization, the rights to such income in another, the Supreme Court has developed the doctrine of anticipatory assignments of income: [18]

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, ... who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule [of realization], founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. This may occur when he has made such use or disposi-

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States, 366 U.S. 213, 219, 6 L.Ed.2d 246, 81 S.Ct. 1052 (1961) (noting "intention of Congress to tax all gains except those specifically exempted," and defining gross income broadly to include all gains from which, "when its recipient has such control over it . . . , as a practical matter, he derives readily realizable economic value") (citations and quotations omitted).

[17] *Helvering v. Horst, 311 U.S. 112, 116, 85 L.Ed.2d 75, 61 S.Ct. 144 (1940)* (noting "the rule that income is not taxable until realized").

[18] *Lucas v. Earl, 281 U.S. 111, 115, 74 L.Ed. 731, 50 S.Ct. 241 (1930).*

tion of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. ...

[Under the anticipatory assignment of income doctrine,] income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. *Horst, 311 U.S. 112 at 115-17, 61 S. Ct. 144, 85 L. Ed. 75* (citations omitted). The doctrine does not allow a taxpayer to evade tax through an "arrangement by which the fruits are attributed to a different tree from that on which they grew." *Earl, 281 U.S. 111 at 115, 50 S. Ct. 241, 74 L. Ed. 731.*

In other words, what is taxed is not exclusively the receipt of funds, but rather any enjoyment of gain, whether monetary or non-monetary. For example, in the landmark *Earl* case, the taxpayer had contracted with his wife for her to receive half of any of his future income. The Court concluded that such an arrangement constituted an anticipatory assignment of income and attributed all of the income to the husband. *Id. at 113-15.*

Similarly, in *Horst,* the taxpayer, a holder of a coupon bond, had made a gift of interest coupons while retaining title to the bond. The Court again held that such an arrangement constituted an anticipatory assignment of income. *See Horst, 311 U.S. at 119-20.* In both cases, the

taxpayer kept control of the asset or income source and merely committed future income streams to another. Such arrangements cannot be used to evade tax.

On the other hand, the doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset or income source to another, because the taxpayer ceases to receive any income from that asset (excepting, of course, any gain realized from the sale). After all, a taxpayer no longer enjoys the fruits of a tree he no longer owns, just as a taxpayer does not receive income from "the rent from a lease or a crop raised on a farm after the leasehold or the farm has been given away." *Id. at 119* (citing *Blair v. Commissioner, 300 U.S. 5, 12-13, 81 L. Ed. 465, 57 S. Ct. 330 (1937)).* Thus, where a stockholder had assigned to a corporation his entire interest in a claim of uncertain value against the government, this court held that the anticipatory assignment of income doctrine did not apply, because the stockholder had fully divested himself of the claim and thus no longer received any income from that asset. *See Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962).*

B.

The question, therefore, is one of characterization, and, as we have recognized, is not always easy to apply in particular cases. [19] There are, to be sure, "distinct" and

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[19] *See Jones, 306 F.2d at 296* (stating that anticipatory assignment of income cases "are not easy to decide. In seeking to reconcile the implications of the infinite variety of facts presented by the decided cases and all that has been said about the subject of anticipatory assignment of income, one is likely to be displeased with his own wits; and may find his mind teetering between conflicting conclusions. . . . 'Drawing the line' is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind.").

identifiable principles which have been developed in tax jurisprudence which serve to guide ... courts." *Id at 296.* As we shall see, however, contingent fee contracts defy easy categorization, standing as they do somewhere in between the two poles—on the one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of an income source.

1.

The most widely-applied principle for implementing the anticipatory assignment of income doctrine is that a taxpayer who makes an assignment of future income streams but retains ownership and control over the source of those funds has effected an anticipatory assignment of income. [20] The principle rests on the sound inference that a taxpayer who retains control over the tree, while handing out its fruits, is in fact continuing to enjoy the benefits of both. By contrast, a taxpayer who had divested all dominion and control over a tree cannot be said to enjoy gain from its subsequent fruits.

Application of the taxpayer-dominion-and-control principle to the case of contingent attorney's fees yields no obvious answer, however. We need not explore the entire realm of attorney-client relations or articulate all of their respective rights, duties, and obligations to recog-

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[20] *See Horst, 311 U.S. at 119* ("We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee."); *Commissioner v. First Sec. Bank, 405 U.S. 394, 403, 31 L.Ed.2d 318, 92 S.Ct. 1085 (1972)* ("In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it").

nize that, when a client hires an attorney to prosecute a claim on his behalf, control over that claim—the income source or "tree"—is neither fully divested to the attorney nor fully retained by the taxpayer-client. Rather, the claim is subject to a sort of virtual co-ownership—"like an interest in a partnership agreement or joint venture." *Clarks, 202 F.3d at 857.*[21]

To put it another way, contingent fee arrangements, to be sure, assign a percentage of the proceeds of any judgment or settlement agreement—the "fruit" of the tree—to the attorney, thereby avoiding realization by the client of that portion of income. But attorney retainer agreements accompanied by contingent fee provisions assign *more* than just the fruit—and yet divest clients of something less than the entire tree. Contingent fees are thus in a sense more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract.

202 F.3d at 857-58.

The control test thus leaves us in a quandary. In light of this ambiguity, a number of other factors might be considered.

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It might be urged, for example, that, unlike the assignees in *Earl* and *Horst*, an attorney must perform to reap

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[21] *But see Kenseth, 2000 U.S. Tax Ct. LEXIS 32,* at 31 ("Attorneys represent the interests of clients in a fiduciary capacity. It is difficult, in theory or fact, to convert that relationship into a joint venture or partnership.").

the benefits of the contingent fee agreement. [22] Certainly, a client contemplates that an attorney will work to earn his contingent share of any award. Indeed, the Sixth Circuit has so noted:

> Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it. *Id.*

Similarly, some courts have noted that *Earl* and *Horst* involved gratuitous transfers. [23] A contingent fee agreement, by contrast, is an arm's-length commercial transaction, we are hard-pressed to imagine a client who would offer his attorney a pure gratuity.

The anticipatory assignment of income doctrine does not recognize such distinctions, however, for the purpose of the doctrine is simply to capture the taxpayer who diverts a stream of income to achieve gain in non-monetary form and to prevent him from evading taxation through such an arrangement.

"Income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received

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[22] *See Clarks, 202 F.3d at 857* (distinguishing *Earl* and *Horst* on the ground that "the assignee [in those cases] performed no services in order to receive the income").

[23] *See Jones, 306 F.2d at 302* ("No gratuity or gift is involved here as has been involved in numerous other cases. So far as the record discloses, the assignment contract was an arm's length transaction.").

himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them."

Horst, 311 U.S. at 117.

It therefore may be true that gratuitous transfers are particularly good opportunities for a taxpayer to enjoy his fruits in advance of realization by, for example, giving them away to loved ones, as in *Earl,* involving a transfer between spouses. There is nothing about arm's-length transactions that need preclude anticipatory assignments in that context, however. To the contrary, a taxpayer who anticipatorily assigns future streams of income to obtain services in return has quite obviously procured a benefit. [24]

Thus, where a medical partnership arranged for its patient group to fund a separate retirement trust for the benefit of the partnership's physicians, without ever vesting those funds in the partnership, the Supreme Court applied the anticipatory assignment of income doctrine and required the partnership to pay tax on the funds deposited into the retirement trust. *See United States v. Basye, 410 U.S. 441, 448-53, 35 L. Ed. 2d 412, 93 S.*

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[24] *See Kenseth, 2000 U.S. Tax Ct. LEXIS 32,* at 26 n.4 ("The transfer of trees in and of itself could be consideration in kind and result in gains to the taxpayer. More significantly, if the trees are analogous to the taxpayer's chose in action or compensatory rights, then the transfer represents a classic anticipatory assignment of income.").

Ct. 1080 (1973). That the payment was made at arm's length, rather than as a gratuity, was of no significance.

3.

Nor, as some courts have suggested, does uncertainty as to the value—indeed, not even uncertainty as to the *fact*—of a contingent fee preclude application of the anticipatory assignment doctrine. [25] There is no questioning the fact that the value of a claim is often uncertain and difficult to predict. [26] But just because a future income stream (or "harvest," if you will) is of uncertain value does not mean a taxpayer cannot achieve gain from anticipatorily assigning it to another. The taxpayer in

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[25] *See First Sec. Bank, 405 U.S. at 403-04* (noting that "the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another"); *Jones, 306 F.2d at 301* ("We believe it appropriate to point out that the claim . . . was at the time of assignment . . . uncertain, doubtful and contingent."); *Clarks, 202 F.3d at 857* (noting that, in *Earl* and *Horst*, "the income assigned to the assignee was already earned, vested, and relatively certain").

[26] *See Jones, 306 F.2d at 301* ("Indeed, lawsuits are rarely certain and free of doubt. Experienced lawyers have long since learned that it is unwise and indeed, ultra foolish to predict the results of litigation. . . . When this assignment was made over five months before the Court of Claims announced its decision, over nine months before the decision became final, and over fourteen months before payment was received, the 'tree' appeared to be blighted and almost devoid of life. It had borne 'no fruit' and to a layman . . . , while hopeful and confident because he believed in the justice of his claim, certainly he could not be said to have sufficient insight reasonably to speculate what the United States Court of Claims would ultimately decide."); *Cotnam, 263 F.2d at 125* (Rives and Brown, JJ., concurring) (noting that taxpayer who merely had a claim to pursue in court was "a long way from having the equivalent of cash. Her claim had no fair market value, and it was doubtful and uncertain as to whether it had any value.").

Earl, after all, was taxed on the portion of his future salary anticipatorily assigned to his spouse; that there was some degree of inherent uncertainty in his future income stream went without comment and did not preclude application of the doctrine. *See Earl, 281 U.S. at 113-15.* [27]

4.

The main reason for a client to sign a contingent fee contract, presumably, is not to avoid taxation by anticipatorily assigning future streams of income to others in exchange for non-moneatry benefits. More likely, he signs it to secure the services of an attorney without having to put any capital at risk, and to encourage the attorney to perform well by offering a personal stake in the claim.

A taxpayer who enters into the contract recognizes that, to realize and maximize the value of his claim, he must necessarily obtain the resources and expertise of counsel. [28] But of course, the same is true of a client

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[27] *See also Baylin, 43 F.3d at 1455* (noting that the "temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees."); *Kenseth, 2000 U.S. Tax Ct. LEXIS 32*, at 30-31 ("Despite characterizing petitioner's right to recovery as speculative, his cause of action had value in the very beginning; otherwise, it is unlikely that [his attorneys] would have agreed to represent petitioner on a contingent basis.").

[28] *See Cotnam, 263 F.2d at 125-26* (Rives and Brown, JJ., concurring) ("The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. . . . [Her] claim . . . was worthless without the aid of skillful attorneys. At the time that she entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder. . . . She could never have collected anything or have enjoyed any

[footnote continued]

who retains counsel on a non-contingent fee basis. The fact that a contingent fee arrangement has the added benefits of risk-shifting and realignment of incentives does not alter the economic reality. Such an arrangement diverts a portion of the litigation proceeds from the client to the attorney, thereby accruing to the client non-monetary gain from enjoying the assistance of counsel without otherwise having to pay for it. [29] That gain—no less than the non-monetary gains recognized as income in *Earl*, *Horst*, and their progeny—is not to be excluded from gross income solely on the basis that the money is diverted to, and realized by, the taxpayer's assignee.

That is to say, if there were no contingent fee arrangement, Srivastava presumably would have had to compensate counsel out of his own pocket, rather than rely wholly on the income stream arising from his claim. He ought not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent

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economic benefit unless she had employed attorneys . . . ."); *Clarks, 202 F.3d at 857* ("The value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. The only economic benefit Clarks could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder.").

[29] *See Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729, 73 L.Ed. 918, 49 S.Ct. 499 (1929)* ("The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."); *Baylin, 43 F.3d at 1454* (reasoning that "although the partnership did not take actual possession of the funds it paid to its attorney, opting instead to pay him directly out of its eventual recovery, it is evident that the partnership received the benefit of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount").

basis, [30] for his attorney's method of compensation did not meaningfully affect the gain he was able to enjoy from a favorable resolution of the litigation.

C.

Thus, were we to decide this case as an original matter, we might apply the anticipatory assignment doctrine to hold that contingent fees are gross income to the client. We do not, however, decide this case on a clean slate, but must follow the contrary approach endorsed in *Cotnam*.

Cotnam dealt with a contingent fee agreement governed by Alabama law. A majority of that panel held that contingent attorney's fees are not subject to tax under the anticipatory assignment of income doctrine. The majority reasoned that, before judgment or settlement, a claim is of uncertain value, and that the lawyer's services are necessary to convert that claim into value to the taxpayer. *See Cotnam, 263 F.2d at 125-26* (Rives and Brown, JJ., concurring). [31] Applying the familiar tree/

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[30] *See Kenseth, 2000 U.S. Tax Ct. LEXIS 32,* at 26 (observing that "taxable recoveries in lawsuits are gross income in their entirety to the party-client and . . . associated legal fees – contingent or otherwise – are to be treated as deductions") (footnote omitted).

[31] The additional language offered by Judges Rives and Brown offers the best insight into the majority's reasoning. Technically, it is Judge Wisdom's opinion that speaks for the court. As he expressly notes in his majority opinion, however, Judge Wisdom speaks not for himself, but only for Judges Rives and Brown, in excluding contingent attorney's fees from gross income. *See Cotnam, 263 F.2d at 125* ("A majority of the Court, Judges Rives and Brown, hold that [attorney's fees] should not be included in [the taxpayer's] gross income."). *See also id at 126-27* (Wisdom, J., dissenting). We therefore take little guidance from Judge Wisdom's majority opinion, which speaks narrowly to the attorney's rights under Alabama law governing contingent fees and offers only cursory analysis to support the ultimate judgment.

fruit metaphor of *Earl*, the majority explained that "Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." *Id. at 126* (Rives and Brown, JJ., concurring).

The Commissioner invites us to distinguish *Cotnam* on the ground that we are faced with contingent fees governed by the law of Texas, not Alabama. The distinction rests on the predicate that Alabama gives its contingent fee attorneys a greater degree of power to enforce their rights than does Texas. [32]

These distinctions, however, should not affect the analysis required by the anticipatory assignment of income doctrine, which looks to the taxpayer's degree of control and dominion over the asset. As we have said, a taxpayer who enters into a contingent fee contract divests some measure of control over a claim but retains the rest, and how much control is sufficient to trigger taxation under the anticipatory assignment of income doctrine is not easily answerable. But we find no assistance from the fact that Alabama may offer its contingent fee attorneys, by way of example, greater power to pursue relief directly against the *opposing party*. Whatever are the attorney's rights against the *defendant* under Texas law as opposed to Alabama law, the discrepancy does not meaningfully affect the economic reality facing the *taxpayer-plaintiff*. [33]

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[32] *Compare* ALA CODE §34-3-61 *with Dow Chem. Co. v. Benton, 163 Tex. 477, 357 S.W.2d 565 (Tex. 1962).*

[33] The dissent would distinguish *Cotnam* by limiting it to those contingent fee arrangements in which – as Alabama law provides – an attorney can pursue a claim against the opposing

[footnote continued]

We therefore agree with the Tax Court that, irrespective of whether it is proper to tax contingent attorney's

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party on his own, apart from the client's decision to pursue that claim. *See* ALA. CODE §34-3-61(b) (stating that "attorneys-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them"). By contrast, the dissent would include, within gross income, contingent fees governed by Texas law, for, under Texas law, as the dissent correctly notes, "even when the attorney has been assigned an ownership interest in his client's cause of action, his rights remain wholly derivative from those of his client," and "the client's action is indivisible and may not be tried for only a percentage of the cause of action." *See also Dow, 357 S.W.2d at 467-68.*

That this distinction is without a difference for purposes of the anticipatory assignment of income doctrine, however, is made clear simply by comparing the laws governing contingent fee arrangements in Alabama and Texas to the Supreme Court's two landmark decisions establishing the doctrine. In *Horst*, the taxpayer, "the owner of negotiable bonds, [had] detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity." *See Horst, 311 U.S. at 114.* That arrangement is similar to the severable contingent fee agreement provided under Alabama law and at issue in *Cotnam*; like the Alabama contingent fee lawyer, the holder of the negotiable interest coupon in *Horst* needs no further action from the holder of the underlying negotiable bond to recover on the coupon.

By contrast, in *Earl* (decided ten years before *Horst*), the taxpayer had merely contracted away half of his future salary to his wife. *See Earl, 281 U.S. at 113-14.* Like the Texas contingent fee lawyer, Earl's wife could not enjoy the benefits of the agreement absent the continued efforts of her spouse.

The *Earl* Court – like the instant dissent – reasoned that such an arrangement was not enough to allow the taxpayer to exclude income. In *Horst*, the Court noted that the court below had "thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from *Lucas v. Earl.*" *Horst, 311 U.S. at 114-15.* But the Court rejected that argument, ultimately finding the two cases indistinguishable.

[footnote continued]

fees under the anticipatory assignment doctrine, the answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state. [34] In refusing the Commissioner's request to distinguish *Cotnam* (as the Tax Court has grudgingly done on occasion [35]), we note that what the Commissioner truly seeks is a direct challenge to *Cotnam*, in the Eleventh Circuit [36] as well as here.

Similarly, *Cotnam* is indistinguishable from the instant case, and thus however the anticipatory assignment of income doctrine applies in one case, principles of consistency dictate that the doctrine apply similarly in the other. Rightly or wrongly, this court in *Cotnam* decided not to apply the anticipatory assignment of income doctrine to contingent fee agreements. What the Commissioner and the dissent urge, in effect, is that we use whatever means necessary to avoid *Cotnam*. The Tax Court has already rejected that approach, and we do so as well.

[34] *See O'Brien, 38 T.C. at 712* ("In reaching that conclusion the majority [in *Cotnam*] placed considerable stress upon certain provisions of an Alabama statute relating to attorneys' liens. . . . However, we think it doubtful that the Internal Revenue Code was intended to turn upon such refinements. For, even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even for a split second, it would still be gross income to him under the familiar principles of [*Earl* and *Horst*]."); *Kenseth, 2000 U.S. Tax Ct. LEXIS 32*, at 29 (rejecting distinction, quoting *O'Brien*, and "declining to decide this case based on the possible effect of various States' attorney's lien statutes") (footnote omitted).

[35] *See Kenseth, 2000 U.S. Tax Ct. LEXIS 32*, at 21 ("The *Cotnam* holding with respect to the Alabama attorney lien statutes has been distinguished by this Court from cases interpreting the statutes of numerous other states. Significantly, this Court has, for nearly 40 years, not followed *Cotnam* . . . .") (collecting cases).

[36] *See Davis, 210 F.3d at 1347 n.4; Kenseth, 2000 U.S. Tax Ct. LEXIS 32*, at 29. n.6.

We decline that invitation and, instead, reverse the Tax Court's decision to include contingent fees within gross income and remand for a recalculation of the deficiency.

IV.

The petitioners challenge the Tax Court's decision to attribute portions of the settlement agreement to recovery for actual damages (which are not taxable) and other portions to interest and punitive damages (which are taxable). They contend that the entire settlement represents actual damages.

We determine the tax treatment of judgments and settlements by asking "in lieu of what was the judgment or litigation settlement awarded?" *Knuckles v. Commissioner, 349 F.2d 610 (10th Cir. 1965).* [37] We review the allocations made by the Tax Court only for clear error. *See id. at 612.* Finding none, we affirm that portion of the decision.

The petitioners urge that the settlement ought to represent actual damages exclusively, because the settlement award is identical to the amount their complaint had sought for actual damages. Not only is this factually untrue (in that petitioners prayed for actual damages "in an amount *in excess* of $8,500,000.00"), but it is also not the only plausible explanation, even if we were to restrict our analysis to the pleadings in the underlying state court litigation. We cannot be certain that, in settling the dispute, the parties restricted their attention to actual damages and ignored the petitioners' claim for

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[37] *See also Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944)* (same).

$2,000,000 or more in punitive damages, or their claim for interest.

To the contrary, although it did not state any method of allocation, the tiered settlement agreement demonstrated that the station's insurers were in fact focused on the portions of the verdict awarding interest and punitive damages. The jury awarded the petitioners actual damages of $11.5 million, an amount *below* the level of liability triggering coverage under the Columbia Casualty Company and Hudson Insurance Company policies (that is, below the $12 million to $22 million range). That those two insurers agreed to pay $3 million to settle the litigation strongly suggests—indeed, conclusively indicates—that interest and punitive damages played some role in settlement negotiations.

Nor does this approach in any way undercut the petitioners' assertion that punitive damages were the most vulnerable to reduction, or even outright elimination, on appeal. Based on the Tax Court's methodology, of the $11.5 million awarded by the jury for actual damages, combined with additional sums for interest, Srivastava received $6 million. By contrast, though the jury awarded $17.5 million in punitive damages, the settlement agreement provided only $3 million.

The petitioners also assert that, in settling the dispute, they were motivated solely by concerns regarding the solvency of the various insurers. It is, however, the payor's intent, rather than the payee's that carries the most weight. [38] Moreover, this assertion is undercut by the

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[38] *See Knuckles, 349 F.2d at 613* ("The most important fact in making that determination, in the absence of an express personal injury settlement agreement, is the intent of the payor as to the purpose in making the payment.").

petitioners' claim that they also were concerned about their prospects for upholding the verdict—particularly the punitive damages portion—on appeal. [39]

Even if petitioners were exclusively motivated by collection concerns, that merely addresses the need for some kind of negotiated settlement with the station and its solvent insurers. Such concerns do not implicate, in any way, the allocation of that settlement among actual damages, interest, and punitive damages; indeed, the petitioners' own brief at times unwittingly concedes as much. Their stated motives do not raise the level of doubt about the Tax Court's allocation methodology necessary to trigger reversal for clear error.

The Tax Court correctly concluded that some portion of the settlement was attributable to something other than actual damages. Of course, some arbitrariness is inevitable when segregating a litigation settlement into different categories of recovery in specific amounts. But the petitioners argue only that the Tax Court ought to have allocated the entire settlement to actual damages. They fail utterly to show that the court's judgment to the contrary, and the allocation methodology the court subsequently adopts, constitute clear error. We therefore affirm the Tax Court's decision with regard to interest and punitive damages.

V.

Regarding the assessment of penalties, the Internal Revenue Code provides that "there shall be added to the

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[39] In their initial brief on appeal, the petitioners claim that collectability was their exclusive concern. But in their reply brief, they admit that they also had concerns about sustaining the jury award of punitive damages in the state appellate court.

tax an amount equal to 20 percent of the portion of ... any underpayment which is attributable to 1 or more of the following: ... (2) Any substantial understatement of income tax." *26 U.S.C.* §*6662* (a), (b). An understatement is "substantial" if it is both more than "(i) 10 percent of the tax required to be shown on the return for the taxable year" and more than "(ii) $5,000." *26 U.S.C.* §*6662*(d)(1)(A). "No penalty shall be imposed ... with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." *26 U.S.C.* §*6664*(c)(1). [40]

Our reversal of the Tax Court's decision to include contingent fees in gross income naturally gives the petitioners reasonable cause for failing to pay tax on that portion of the settlement, and the Commissioner does not challenge the Tax Court's refusal to penalize the petitioners for their failure to pay tax on the punitive damages portion. [41] Therefore, the only portion of the deficiency vulnerable to penalty is that portion of the settlement award representing interest (after contingent fees are excluded).

We must remand to the Tax Court to determine whether interest (excluding contingent fees) is alone sufficient to constitute a substantial understatement of tax—that is, whether the understatement is both more than "(i) 10 percent of the tax required to be shown on the return for the taxable year" and more than "(ii) $5,000." *26 U.S.C.* §*6662*(d)(1)(A). If the Tax Court determines

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[40] *See also Treas. Reg.* §*1.6664-4.*

[41] *See* note 5, *supra.*

that the underpayment attributable to interest alone is "substantial" under the statutory definition, the penalty should be assessed, because there was no reasonable cause for failure to pay tax on that portion of the settlement.

For reasons already discussed, the petitioners erred in failing to pay that tax. They argue, however, that they should not be penalized for that failure because they reasonably relied on the advice of professionals. Reviewing the Tax Court's rejection of the petitioners' argument only for clear error, [42] we affirm.

Under the governing Treasury Regulations, reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. ... Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Treas. Reg. §*1.6664-4(b)(1).* "Reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law." *Treas. Reg.* § *1.6664-4(c)(1).*

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[42] *See Treas Reg.* §*1.6664-4(b–(1)* ("The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances."); *Streber v. Commissioner, 138 F.3d 216, 219 (5th Cir. 1998)* ("This court reviews the tax court's findings of negligence under the clearly erroneous rule. Clear error exists when this court is left with the definite and firm conviction that a mistake has been made.") (citations omitted).

The petitioners seek refuge in the professional advice of their attorney in the state court defamation litigation and their certified public accountant. It was not reasonable to rely on either, however.

Petitioners' attorney in the state court defamation claim testified not only that he is not a tax lawyer, but that he advised his client to seek out a tax lawyer for tax advice. Also, petitioners do not dispute that they never gave their accountant a copy of the settlement agreement, an obviously important factual disclosure that precludes a finding of reasonable reliance, because reliance is *per se* unreasonable "if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item." *Treas. Reg.* §*1.6664-4(c)(1)(i)*.

There was no one both sufficiently qualified and adequately knowledgeable about the case on whom petitioners reasonably could have relied. Consequently, the Tax Court did not clearly err in finding that petitioners lacked reasonable cause to support their substantial underpayment. Therefore, if the Tax Court on remand determines that the failure to pay tax on interest alone (excluding contingent fees) constitutes a substantial underpayment under the statutory definition, the Commissioner may recalculate and assess a new penalty.

VI.

In summary, we REVERSE the Tax Court's decision to tax contingent fees and REMAND for a recalculation of the deficiency and any appropriate penalties. We AFFIRM the Tax Court's allocation of the settlement proceeds among actual damages, interest, and punitive damages.

CONCURBY:
DENNIS (In Part)

DISSENTBY:
DENNIS (In Part)

DISSENT:

DENNIS, Circuit Judge, concurring in part and dissenting in part:

I respectfully dissent from the majority opinion's reversal of the Tax Court's decision to tax the clients on their attorney's fees paid out of recovery of punitive damages and interest thereon. I concur in the balance of the majority's decision, however, for the reasons stated in its opinion.

In my opinion, *Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959),* based in part on Alabama law, is distinguishable and not controlling in the present case based in part on Texas law. In Cotnam a majority of this court's panel held that the amount of a contingent fee paid out of a taxpayer's recovery in a breach of contract action was not income to the taxpayer. The sum was held to be income to the attorneys but not to Mrs. Cotnam, the taxpayer, for the following reasons:

The Alabama Code provides: 'The attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them'. In construing this statute the Alabama courts have given full effect to the statute. Attorneys have the same rights as their clients. *Western Railway Co. v. Foshee, 1913, 183 Ala. 182, 62 So. 500; Denson v. Alabama Fuel & Iron Co., 1916, 198 Ala. 383, 73 So. 525.* Under Alabama law, therefore, Mrs. Cotnam could never have

received the $50,365.83, even if she had settled the case directly with the Bank.

In *United States Fidelity & Guaranty Co. v. Levy, 5 Cir., 1935, 77 F.2d 972, 975,* Judge Hutcheson, speaking for the Court, held that the Alabama statute creates a charge 'in the nature of an equitable assignment . . . (or) equitable lien' in the cause of action. An attorney 'holding such an interest has an equity in the cause of action and the recovery under it prior to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.'

The facts in this unusual case, taken with the Alabama statute, put the taxpayer in a position where she did not realize income as to her attorneys' interests of 40% in her cause of action and judgment. *263 F.2d at 124* (footnote quoting 46 Code of Alabama §64 (1940) omitted).

Under Texas law attorneys do not have the same right and power as their clients in the clients' causes of action, suits, judgments or decrees, to enforce attorney's liens, interests or contingency fee claims against the defendants. In *Dow Chemical Company v. Benton, 163 Tex. 477, 357 S.W.2d 565, 567-68 (1962),* the Texas Supreme Court held that an attorney may not prosecute a cause of action on his own behalf to secure a contingent fee after his client, the original plaintiff, has been properly dismissed from the case for refusal to appear for deposition. The contingent fee contract involved there was virtually identical to the one in the present case. [43] The client had agreed to "sell, transfer, assign

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[43] In the present case, in addition to providing for payment of expenses, the contingent fee agreement between the taxpayers and their attorneys provided in relevant part:

[footnote continued]

and convey to my said attorneys the respective undivided interests in and to my said claim ... and to any judgment or judgments that I may obtain or that may be rendered to me or my heirs and assigns." *357 S.W.2d at 566.* The Texas Supreme Court explained:

> The lawyer's rights, based on the contingent fee contract, are wholly derivative from those of his client. The attorney-client relationship is one of principal and agent. *Texas Employers Ins. Ass'n v. Wermske, Tex., 162 Tex. 540, 349 S.W.2d 90 (1961).* Therefore, the rights of each in a cause of action during the existence of that relationship are necessarily dependent upon and inseparably interwoven with the other. Neither lawyer nor client should be permitted to select the good features of his contract and reject the bad. There is but one cause of action. Our decisions uphold an agreement to assign a part of the recovery on the cause of action to the attorney. But we have never held that the cause of action is divisible and may be tried for only a percentage of the cause of action.

I/We , the undersigned, hereinafter called CLIENTS, employ the law firm of BRANTON & HALL, P.C., hereinafter called ATTORNEYS, understanding that the legal services rendered and to be rendered will be by ATTORNEYS of the professional corporation at its discretion. CLIENTS hereby sell, convey, and assign to BRANTON & HALL, P.C., as consideration for said services a forty percent (40%) interest in and to any and all causes of action, claims, demands, judgment, or recoveries which CLIENTS may hold or receive because of damages and injuries received and sustained by DR. SUDHIR SRIVASTAVA and DR. ELIZABETH PASCUAL as a result of the television broadcasts on Channel 5 in February, 1985.

... As long as the attorney-client relationship endures, with its corresponding legal effect of principal and agent, the acts of one must necessarily bind the other as a general rule.

.... We do not reject the rationale that a properly worded contingent fee contract may effect an assignment of part of the recovery and a part of a cause of action to the attorney. However, the attorney who has received such an assignment invariably elects to litigate his interest simultaneously with his client's interest, in his client's name, and elects implicitly to be bound by any judgment properly rendered in the case. We hold that so long as the existing agency relationship is not terminated, as by the opposite party's buying out the client's interest, the attorney must be bound by that election. *257 S.W.2d at 567-68.*

Consequently, under Texas law, unlike that of Alabama, an attorney is not granted by statute the same right and power as his client over his client's cause of action and judgment for the independent enforcement of his attorney's fee claim. Under Texas law, even when the attorney has been assigned an ownership interest in his client's cause of action, his rights remain wholly derivative from those of his client; the attorney-client relationship remains one of principal and agent; the rights of the lawyer and the client are inseparable, interdependent and interwoven; the client's action is indivisible and may not be tried for only a percentage of the cause of action. As long as the attorney-client relationship endures, the acts of one must necessarily bind the other as a general rule. The attorney who has received an assignment of a part of his client's cause of action is deemed by law to have elected to litigate his interest

simultaneously with his client's interest, in his client's name, and to be bound by any judgment properly rendered in the case. So long as the attorney-client relationship is not terminated by the client's actions purporting to settle the case with the opposite party litigant, the attorney is bound by that election.

For these reasons and others assigned by the Tax Court or acknowledged in the majority's candid opinion, I conclude that the taxpayers in the present case did not by virtue of their attorney-client contract divest themselves of part of their interests in the claim, or vest a legal, independently enforceable ownership interest in that claim in their attorneys. Accordingly, the taxpayers received as income the portions of the settlement consisting of punitive damages and interest that were earmarked for the payment of their attorney's fees, and I believe that the taxpayers must pay taxes on those proceeds. [44] "The taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, cannot escape taxation because he has not himself received payment of it from his obligor. ... [Taxation] may occur when he has made such use or disposition of his

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[44] In response to footnote 33 of the majority opinion, out of an abundance of caution, it should be noted that this case involves only the question of whether a client may avoid payment of income taxes on his recovery of Texas noncompensatory punitive damages which this court held not excluded from the client's gross income by *I.R.C.* §*104(a)(2)*. See *Estate of Moore v. Commissioner, 53 F.3d 712 (5th Cir. 1995)*. This case does not affect §104(a)(2)'s exclusion from gross income of a client's recovery of compensatory damages for personal injuries or sickness or the exclusions from gross income of punitive damages by *I.R.C.* §*104-(c)*(1996).

power to receive or control the income as to procure in its place other satisfactions which are of economic worth." *Helvering v. Horst, 311 U.S. 112, 116, 85 L. Ed. 75, 61 S. Ct. 144 (1940).*

APPENDIX G

[FOR PUBLICATION]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 98-71358

Tax Ct. No. 4722-97

FRANKLIN P. COADY; NONA COADY,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from an Order of the
United States Tax Court
David Laro, Tax Court Judge, Presiding

Argued and Submitted
May 5, 2000 – Seattle, Washington

Filed June 14, 2000

Before: Edward Leavy, Pamela Ann Rymer, and
Thomas G. Nelson, Circuit Judges.

Opinion by Judge Rymer

OPINION

SUMMARY

TAX/Income

The court of appeals affirmed a decision of the tax court. The court held that a plaintiff cannot avoid taxation on income in the form of a recovery for back pay and benefits by diverting it to counsel for a contingency fee.

When appellant Nona Coady was discharged from her job with Alaska Housing Finance Corporation (AHFC) she and her husband retained a law firm to represent her in a wrongful termination suit against AHFC for a contingent fee.

After a bench trial, the court held that AHFC was liable to Coady for $89,000 in backpay, $77,000 in lost future earnings and $207,000 in lost fringe and pension benefits. The Coady's paid their attorneys $125,000 in fees and $97,000 in litigation costs.

On their joint income tax return, the Coadys excluded the portion of the award not paid on account of past wages, instead reporting it as self-employment income. They reported the portion of the award paid for back wages as income. They claimed a deduction of $168,000 for attorneys' fees and costs proportionate to the self-employment income, and a miscellaneous itemized deduction of $53,000 proportionate to the wages income.

The Commissioner of the Internal Revenue Service sent the Coadys a notice of deficiency, stating that the entire award should have been included in their gross income and that attorneys' fees and costs were deduc-

tible as a miscellaneous itemized deduction, and asserting a deficiency of $50,000.

The Coadys filed suit in tax court. The tax court held that the $168,000 in legal fees and costs was reportable income. The Coadys appealed.

Under Alaska Law, an attorney obtains a lien that attaches to property belonging to the client; it does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients.

The Coadys received full payment of the judgment from AHFC. Gross income is defined as all income from whatever source derived. Any funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code.

The award was in lieu of wages and compensation, and was clearly gross income. The entire amount of the award was paid to Nona Coady, and was therefore reportable as income. The Coadys simply used a portion of the award subsequently to discharge their personal liability to their attorneys.

The Supreme Court has explicitly rejected the notion that taxation can be escaped by procuring payment directly to creditors or by making anticipatory arrangements to prevent earnings from vesting in the person who earned it.

That an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it. Coady's recov-

ery for back pay and benefits was income to her on which she cannot avoid taxation by diversion to creditors, including counsel for a contingency fee.

COUNSEL

Lance Hulbert, Bothell, Washington, for the petitioners-appellants.

David English Carmack, Karen D. Utiger (signed the brief), and Kenneth W. Rosenberg (argued), United States Department of Justice, Washington, D.C., for the respondent-appellee.

OPINION

RYMER, Circuit Judge:

The issue before us is whether Franklin and Nona Coady were entitled to exclude from their 1994 gross income $168,217 for costs and contingent legal fees incurred in securing Nona Coady's judgment for lost wages and benefits arising out of her wrongful termination. We conclude that they were not, and affirm.

I

In May 1990, Nona Coady was discharged from her position as Senior Loan Officer at Alaska Housing Finance Corporation (AHFC). Along with her husband, Coady retained the law firm of Hellen, Partnow & Condon (HPC) to represent her in a wrongful termination suit against AHFC for a contingent fee of 33.33% (45% if the judgment were appealed) or $185 per hour plus costs. After a bench trial, the court held that AHFC was liable to Coady for $373,307 ($89,225 for back pay, $76,980 for future lost earnings, and $207,225 for lost fringe and pension benefits). AHFC issued a check to Coady for $259,610.89 in full payment of the judgment (withhold-

ing $113,696.11 for federal income taxes, FICA/OASDA, and FICA/MED). The Coadys paid $221,338.32 to HPC ($124,435.67 in attorneys' fees and $96,902.65 in litigation costs).[1]

On their joint 1994 Federal Income Tax Return, the Coadys excluded $284,082 for the portion of the $373,307 award not paid on account of past wages, instead reporting it as self-employment income on Schedule C of their return. They reported as income from wages only that portion of the award that was paid for back wages ($89,225). The Coadys claimed a deduction of $168,217 for attorneys' fees and litigation costs (the amount of fees and costs proportionate to the portion of the award they reported as self-employment income). This resulted in a net income from self-employment of $115,865. The Coadys claimed a miscellaneous itemized deduction of $53,121 for attorneys' fees and litigation costs proportionate to the $89,225 of the award they reported as income from wages.

The Commissioner sent the Coadys a statutory notice of deficiency, stating that the entire $373,307 should have been included in their 1994 gross income and that the attorneys' fees and litigation costs of $221,338 were deductible as a miscellaneous itemized deduction. The Commissioner asserted a deficiency in tax of $49,531 (plus interest). The Coadys filed suit in tax court. The case was submitted on a fully stipulated record, and the Coadys conceded that the $284,082 reported on Schedule C should not have been reported as self-employment income on Schedule C but should have been

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[1] Litigation expenses totaled $99,951.74. The Coadys had deposited $3,300 as advance payment of legal costs in 1993.

reported along with the $89,225 as income from wages. The parties agreed that the $53,121 was deductible as a Schedule A "Miscellaneous Deduction." The parties disagreed as to whether the remaining legal fees and costs of $168,217 ($221,338 less $53,121) constituted reportable income. The Commissioner contended that the fees and costs were deductible as a Schedule A "Miscellaneous Deduction." The Coadys argued that the fees and costs were not reportable income at all.[2] The tax court upheld the Commissioner's determination. The Coadys appeal.

II

The Coadys contend that they are entitled to exclude $168,217 from gross income because they "assigned" that portion of their settlement to counsel. They rely on *Cotnam v. C.I.R.*, 263 F.2d 119 (5th Cir. 1959). There, the taxpayer (Ms. Cotnam) won a contract action against the estate of T. Shannon Hunter, who had promised Cotnam one-fifth of his estate in return for her serving him as an attendant. Hunter died without a will, but Cotnam sued and was awarded $120,000, of which $50,365.83 was paid to her attorneys as a contingency fee. After Cotnam paid her taxes, exempting the award as a bequest, the Commissioner determined a deficiency in tax of $36,985.02. The Fifth Circuit Court of Appeals first reasoned that the amount Cotnam received was not exempt as a bequest but was taxable income for services rendered. *See id.* at 121.

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[2]Pursuant to 26 U.S.C. §67(b), all itemized deductions not falling within the enumerated list in that subsection are called "miscellaneous itemized deductions." Miscellaneous itemized deductions may be deducted from the taxpayer's income "to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." 26 U.S.C. §67(a).

However, the panel split as to whether the fee paid to Cotnam's attorney should be included in her gross income. Judge Rives and Judge Brown concluded that the $50,365.83 paid to Cotnam's attorneys "should not be included in her gross income. This sum was income to the attorneys but not to Mrs. Cotnam." *Id.* at 125. Under Alabama law, "[a]ttorneys have the same rights as their clients." *Id.* Pursuant to 46 Code of Alabama §64 (1940):

> Upon suits, judgments, and decrees for money, they shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

Cotnam "could never have received the $50,365.83, even if she had settled the case directly with the Bank." *Id.* at 125. The Alabama statute "creates a charge 'in the nature of an equitable assignment (or) equitable lien' in the cause of action. An attorney 'holding such an interest has an equity in the cause of action and the recovery under it *prior* to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.' " *Id.* at 125 (quoting *United States Fidelity & Guaranty Co. v. Levy*, 77 F.2d 972, 975 (5th Cir. 1935)) (emphasis added). Accordingly, the court concluded that based on the Alabama statute, the taxpayer was "in a position where she did not realize income as to her attorneys' interests of 40% in her cause of action and judgment." *Id.* Judge Wilson dissented, reasoning that "at the time of the assignment

to the attorneys all of her services had been rendered and all of the income earned." *Id.* at 126 (Wisdom, J. dissenting).

The rule in *Cotnam* has been subject to disagreement among the circuit courts of appeals. The Sixth Circuit recently followed *Cotnam* in *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), concluding that the interest portion of an attorney's contingency fee should not be included in the client's gross income. *See id.* at 855-56. The court reasoned that the "common law lien in this case under Michigan law operates in more or less the same way as the Alabama lien in *Cotnam*" because "[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment." *Id.* at 856. According to the *Clarks* court:

> In the instant case, as in *Cotnam*, the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy . . . . Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds. Just as in *Cotnam*, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.

Id. at 857.

However, the Federal and First Circuits have declined to follow *Cotnam*. In *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), the Federal Circuit rejected a taxpayer's claim that because a portion of an award was

paid directly to the taxpayer's attorneys, that portion was never part of its gross income: "Very little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership [the taxpayer] to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement." *Id.* at 1454 (citation omitted). *Baylin* reasoned that

> [A]lthough the partnership did not take actual possession of the funds it paid to its attorney, opting instead to pay him directly out of its eventual recovery, it is evident that the partnership received the benefit of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount. The fee arrangement signifies the value that the parties placed on the attorney's services. In other words, the partnership "made such use or disposition of [its] power to receive . . . the income as to procure in its place other satisfactions which are of economic worth." *Helvering v. Horst*, 311 U.S. 112, 116, 61 S.Ct. 144, 85 L.Ed. 75 (1940).

Id. at 1454-55 Additionally, the court stated:

> That the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery and by having the obligation of the client to the attorney discharged by having the state pay the attorney his fees directly from the recovery. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment

> cannot dictate the income tax treatment of those fees.

Id. at 1454; *see also Alexander v. Internal Revenue Service*, 72 F.3d 938, 944-46 (1st Cir. 1995) (holding that legal fees expended in procuring a settlement for the loss of salary and retirement benefits should be included in gross income and are deductible as a miscellaneous itemized deduction).

We are persuaded by *Baylin*, *Alexander*, and Judge Wisdom's dissent in *Cotnam*. This case is unlike *Cotnam* and *Clarks* because under Alaska law, attorneys do not have a superior lien or ownership interest in the cause of action as they do in Alabama and Michigan:

> (a) An attorney has a lien for compensation, whether specially agreed upon or implied, as provided in this section
>
> > (1) first, upon the papers of the client that have come into the possession of the attorney in the course of the professional employment;
> >
> > (2) second, upon money in the possession of the attorney belonging to the client;
> >
> > (3) third, upon money in the possession of the adverse party in an action or proceeding in which the attorney is employed, from the giving of notice of the lien to that party;
> >
> > (4) fourth, upon a judgment to the extent of the costs included in the judgment or, if there is a special agreement, to the extent of the compensation specially agreed on, from the giving of notice of the lien to the party against whom the judgment is given and filing the original with the clerk where the judgment is entered and docketed.

> (b) This lien is, however, subordinate to the rights existing between the parties to the action or proceeding.

Alaska Stat. §34.35.430. According to the statute, an attorney obtains a lien which attaches to property belonging to the client; it does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients. *See Hagans, Brown & Gibbs v. First Nat. Bank of Anchorage*, 783 P.2d 1164, 1168 (Alaska 1989).

The Coadys received full payment of the judgment from AHFC. Title 26 U.S.C. §61(a) defines gross income very broadly as "all income from whatever source derived." "[A]ny funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code." *Getty v. C.I.R.*, 913 F.2d 1486, 1490 (9th Cir. 1990).

To determine whether an award of damages or a settlement payment constitutes gross income, we look to " 'the nature of the underlying action.' " *Id.* (quoting *Tribune Pub. Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988)). We ask: "In lieu of what were the damages awarded?" *Id.* (internal quotations omitted). Here, the award was in lieu of wages and compensation, and is clearly gross income. *See Commissioner v. Schleir*, 515 U.S. 323, 328-30 (1995) (back wages received on account of wrongful termination constitute gross income); *Commissioner v. Smith*, 324 U.S. 177, 181 (1945) (any economic or financial benefit conferred on the employee as compensation constitutes gross income). The entire amount of the award was paid to Nona Coady, and there-

fore reportable as income. The Coadys simply used a portion of the award subsequently to discharge their personal liability to their attorneys.

The Supreme Court has explicitly rejected the notion that taxation can be escaped by procuring payment directly to creditors or by making anticipatory arrangements to prevent earnings from "vesting even for a second" in the person who earned it. *See Lucas v. Earl,* 281 U.S. 111, 114-15 (1930) ("There is no doubt that the [Revenue Act] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."). "[T]he rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor." *Helvering v. Horst,* 311 U.S. 112, 116 (1940). Even if the taxpayer "procures payment directly to his creditors of the items of interest or earnings, . . . he does not escape taxation because he did not actually receive the money." *Id.* (citations omitted); *see also Helvering v. Eubank,* 311 U.S. 122, 124-25 (1940); *United States v. Bayse,* 410 U.S. 441, 449 (1973) ("[I]ncome must be taxed to him who earns it . . . . The entity earning the income . . . cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity.") (citations omitted); *Chugach Alaska Corp. v. United States,* 34 F.3d 1462, 1467 (9th Cir. 1994) (same).

The Coadys argue that these cases are distinguishable because here there was the existence of real doubt at the time of the assignment of the contingency fee. However, we have previously held that the fact that such an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it. *See Kochansky v. C.I.R.*, 92 F.3d 957, 959 (9th Cir. 1996) (portion of a contingency fee that a lawyer assigned to his ex-wife was taxable to the lawyer, not to his wife despite the fact that the fee was "uncertain, doubtful, and contingent" at the time the lawyer assigned it). So has the Federal Circuit. *See Baylin*, 43 F.3d at 1454-55. Therefore, we conclude that Coady's recovery for back pay and benefits was income to her on which she cannot avoid taxation by diversion to creditors, including counsel for a contingency fee.

III

In the alternative, the Coadys contend that their arrangement with HPC establishes a joint venture or partnership for federal tax purposes under §7701(a)(2). However, we decline to consider this argument because the Coadys failed to raise it in the Tax Court. *See Broad v. Sealaska Corp.*, 85 F.3d 422, 430 (9th Cir. 1996).

AFFIRMED.

APPENDIX H

LEXSEE 72 f3d 938

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 95-1451

J. KENNETH ALEXANDER and
JOANNA M. ALEXANDER,

Petitioners-Appellants,

v.

INTERNAL REVENUE SERVICE OF
THE UNITED STATES OF AMERICA,

Respondent-Appellee.

72 F.3d 938; 1995 U.S. App. LEXIS 36342;
96-1 U.S. Tax Cas. (CCH) P50,011;
77 A.F.T.R.2d (RIA) 301

December 22, 1995, Decided

COUNSEL:

Philip J. Ryan, with whom Ryan, Martin, Costello, Leiter, Steiger & Cass, P.C. was on brief for appellants.

William J. Patton, Attorney, Tax Division, Department of Justice, Loretta C. Argrett, Assistant Attorney General, Gary R. Allen, Attorney, and Richard Farber, Attorney, Tax Division, Department of Justice, were on brief for appellee.

JUDGES:
Before Torruella, Chief Judge, Aldrich and Coffin, Senior Circuit Judges.

OPINIONBY:
TORRUELLA

OPINION:

TORRUELLA Chief Judge. Respondent-Appellee, the Commissioner of Internal Revenue (the "Commissioner"), determined a deficiency of $57,441 in the 1989 Federal income tax filed by J. Kenneth Alexander (the "Taxpayer") and Joanne M. Alexander (together, the "Appellants" or the "Petitioners"). The Tax Court upheld the Commissioner's determination and the Petitioners now seek review of that decision. For the reasons stated below, we affirm.

I. BACKGROUND

The pertinent facts, some of which have been stipulated and incorporated in the district court's findings, are not in dispute, and are recapitulated here. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for 1989. Internal Revenue Code, *26 U.S.C.* §1 et seq. (1988 & Supp. 1991).

In 1983, Taxpayer entered into an employment agreement with his employer, W. F. Young, Inc. ("Young"), according to which Taxpayer would remain in the capacities of Executive Vice President, Treasurer, and Chief Executive Officer until he reached the age of seventy (70), on December 13, 1993. On October 15, 1987, when Taxpayer was sixty-four (64) years old, Young terminated Taxpayer's employment. Subsequent to his termination, Taxpayer offered management consulting services for a fee, and in 1989 obtained a man-

agement consulting contract with the Hanson Group of Ludlow, Massachusetts.

On February 10, 1988, Taxpayer filed a civil lawsuit against Young (the "lawsuit"), in which Taxpayer was represented by the law firm of Ryan & White, P.C. ("Ryan & White").[1] In his complaint, Taxpayer alleged a breach of the express 1983 employment contract (or "Count I"), a breach of an implied pension benefits contract (or "Count II"), and age discrimination under Massachusetts General Law, Chapter 151B, Section 1 (1976) (or "Count III").

On May 1, 1989, Taxpayer and Young executed a written settlement agreement (the "Settlement Agreement"), according to which Young was to pay Taxpayer $350,000, of which $100,000 was allocated to Count III, and $250,000 to Counts I and II.[2] On May 5, 1989, as per the Settlement Agreement, Young issued two checks payable to "J. Kenneth Alexander and Ryan & White, Attorneys for J. Kenneth Alexander," one in the amount of $100,000 (for Count III), and the other in the amount of $225,395.20 (for Counts I and II, less taxes withheld).

On the 1989 Federal income tax return, Taxpayer's tax preparer deducted $245,100 from the settlement

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[1] J. Kenneth Alexander v. W.F. Young, Inc., Civil Action No. 82-243 (Mass. Superior Court, Hampden County 1988).

[2] The Settlement Agreement also provided that (i) Taxpayer would be deemed to have retired from Young effective October 15, 1987; (ii) Taxpayer would receive monthly payments commencing on May 15, 1989, and continuing for the duration of Taxpayer's life, which total over $70,000 per year; and (iii) Taxpayer and Young executed releases, according to which Alexander surrendered all claims arising out of his employment and its termination.

proceeds attributable to Counts I and II. This deduction was explained in an attached statement, which stated that Taxpayer paid Ryan & White $258,000 in legal fees (the "Legal Fee").[3] It also stated that according to Ryan & White's time allocations, 5% of the Legal Fee was attributable to settlement of Count III, and 95% to settlement of Counts I and II. Accordingly, $245,100 (95% of the $258,000 Legal Fee) was deducted from the settlement proceeds attributable to Counts I and II.

The Commissioner sent a notice of deficiency disallowing Taxpayer's direct deduction of the Legal Fee from the settlement proceeds. The Commissioner determined that the $250,000 received from Young in settlement of Counts I and II was gross income to Taxpayer, and that the Legal Fee associated with Counts I and II were miscellaneous itemized deductions. Accordingly, the Commissioner reduced the $245,100 deduction reported on the 1989 return to $240,198, due to the increase in Taxpayer's adjusted gross income and the two percent (2-percent) adjusted gross income limitation for miscellaneous deductions. In addition, the Commissioner determined that, due to these adjustments, Taxpayer was liable for the Alternative Minimum Tax ("AMT") under Section 55 of the Code, which resulted in a deficiency of $57,441.

Petitioners filed a petition in the United States Tax Court for redetermination of the deficiency. The Tax

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[3]The additional information included in the statement attached to Petitioners' 1989 return, entitled "Disclosure Under Reg. Sec. 1.6661," is not included here because it is not essential for the disposition of the issue on appeal.

Court rejected Petitioners' arguments, entering a final judgment on January 31, 1995, upholding the Commissioner's determination of Petitioners' tax deficiency. This appeal followed. We have jurisdiction pursuant to *26 U.S.C. §7482(a)(1).*

II. DISCUSSION

The only issue on appeal is the proper tax treatment of the Legal Fee. We must determine whether the Petitioners properly deducted the Legal Fee from the settlement proceeds under Section 1001. If we find that they did not, then we must determine whether to treat the Legal Fee as an "above the line"[4] trade or business deduction under Section 162 of the Code, or as a miscellaneous itemized deduction "below the line."[5]

On appeal, Petitioners essentially contend that the Tax Court's decision to uphold the Commissioner's deficiency finding is caused by the erroneous determination that Taxpayer was in the trade or business of "the performance of services as an employee during 1989." Petitioners correctly assert that the defining issue is whether Taxpayer was Young's "employee" for purposes of classifying the settlement proceeds and for determining the deductibility of the Legal Fee under Section 62(a)(1). Although we agree with Petitioners'

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[4]We make reference to the "line" on the federal income tax form where adjusted gross income is calculated.

[5]Petitioners do not dispute that by treating the Legal Fee "below the line" the amounts involved trigger the AMT and, thus, their tax deficiency. We recognize that it is this ramification which drives Petitioners' challenge to the Commissioner's determination that the Legal Fee is to be treated as a miscellaneous itemized deduction.

formulation of the defining issue, we reject their arguments and affirm the court below.

A. Standard of Review

We review the Tax Court's decision "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." *26 U.S.C. §7482*(a). The treatment of the Legal Fee is purely a question of law and, therefore, subject to de novo review. *Estate of Robertson v. Commissioner, 15 F.3d 779, 781 (8th Cir. 1994);* see also First National Bank in *Albuquerque v. C.I.R., 921 F.2d 1081, 1086 (10th Cir. 1990)* (stating that de novo review is applied to tax court's findings of law and of ultimate fact derived from applying legal principles to subsidiary facts). The Tax Court's findings of fact will only be disturbed for clear error. *Manzoli v. Commissioner, 904 F.2d 101, 103 (1st Cir. 1990); U.S. v. Thompson, 406 F.2d 1006, 1009 (9th Cir. 1969);* see also *Connor v. Commissioner, 847 F.2d 985 (1st Cir. 1988)* (emphasizing appropriateness of giving weight to Commissioner's well-established views).

B. Characterization of the Legal Fee

Petitioners argue that the Legal Fee was properly subtracted from the amount realized in the settlement, as per Sections 1001 and 1016,[6] in order to determine the

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[6]Section 1001(a) provides, in relevant part:

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 1011 for determining gain . . . .

Section 1011(a) provides, in relevant part,

> The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired,

[footnote continued]

"gain" from the disposition of Taypayer's "valuable intangible assets," the express and implied contracts and resulting lawsuit. In support of their position, Petitioners contend that the Legal Fee was the "cost of the disposition" of Taxpayer's assets because it was incurred *after* Taxpayer's employment was terminated for the "sole purpose" of enhancing their value and disposing of them by obtaining either a settlement or judgment. Petitioners further contend that, because Sections 1001 and 1016 make no distinction between the basis and gain rules for capital or ordinary assets, "there is a 'capital account' for all assets, whether those assets are considered capital or ordinary." Thus, Petitioners conclude, the Legal Fee is an "expenditure ... properly changed to [the assets'] capital account" within the meaning of Section 1016 to be offset against the settlement proceeds in order to determine the "gain" under Section 1001.

Upon de novo review, we reject Petitioners' arguments invoking treatment under Section 1001, and their contention that the Tax Court erred when it rejected them.

In determining the tax treatment of the Legal Fee, we take as our point of departure Section 61(a), which de-

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shall be the basis (determined under Section 1012 . . .) adjusted as provided in Section 1016.

Section 1012 provides, in relevant part,

The basis of property shall be the cost of such property. . . .

Section 1016 provides, in relevant part,

(a) General rule. Proper adjustment in respect of the property shall in all cases be made.

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account . . . .

26 U.S.C. §§*1001*(a), 1011(a), 1012, 1016 (1988 & Supp. 1991).

fines gross income as "all income from whatever source derived," subject to certain exclusions provided in the Code. It includes, and is not limited to "compensation for services, including fees, commissions, fringe benefits, and similar items." See *Helvering v. Clifford, 309 U.S. 331, 334, 84 L.Ed. 788, 60 S.Ct. 554 (1940)* (finding that Congress intended to exert the "full measure of its taxing power" through Section 61(a)). Next, we take into consideration the well-settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as having the same nature as the right compromised. *Parker v. United States, 573 F.2d 42, 49, 215 Ct. Cl. 773* (quoting *Carter's Estate v. Commissioner, 298 F.2d 4192, 194 (8th Cir. 1962))*, cert. denied, *439 U.S. 1046 (1978);* See *Furrer v. Commissioner, 566 F.2d 1115, 1116 (9th Cir. 1977)*, cert. denied, *437 U.S. 903, 57 L.Ed. 2d 1132, 98 S. Ct. 3088 (1978); Clark v. Commissioner, 1994 Tax Ct. Memo LEXIS 274, 67 T.C.M. (CCH) 3105, 1994 T.C. Memo 278 (1994).*

These two considerations lead us to our test: it "is not whether the action was one in tort or contract but rather the question to be asked is 'In lieu of what were the damages awarded?' " *Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113* (1st Cir.) (citation omitted), cert. denied, *323 U.S. 779, 89 L.Ed. 622, 65 C.Ct. 192 (1944);* See *Getty v. Commissioner, 913 F.2d 1486, 1490 (9th Cir. 1990)* (applying Raytheon test in characterizing settlement payment for tax purposes). An amount received in lieu of compensation under an employment contract constitutes gross income to the recipient in the year in which it was received. See *Furrer v. Commissioner, 566 F.2d at 1117* (holding lump sum payment for

termination of an agency relationship is ordinary income); *Heyn v. Commissioner, 39 T.C. 719, 720 (1963)* (holding amount received in consideration of an employment contract is ordinary income); Clark v. Commissioner, 57 T.C.M. (CCH) at (finding that lump sum payment received upon termination of employment contract is ordinary income); *Rev. Rul. 58-301, 1958-1 C.B. 23, 24* (holding lump sum payment received by an employee as consideration for the cancellation of his employment contract constitutes gross income to the recipient in the taxable year of receipt); cf. *Rev. Rul. 80-364, 1980-2 C.B. 294* (illustrating by way of three hypothetical examples the income and employment tax consequences of interest and attorney's fees awarded in connection with claims for back wages).

Under this rubric, whether Taxpayer's employment contracts are "property" or "intangible assets" in the abstract is irrelevant to the proper analysis of the characterization of the settlement proceeds and, thus, the proper tax treatment of the Legal Fee. The Supreme Court's decision in *Hort v. Commissioner, 313 U.S. 28, 85 L. Ed. 1168, 61 S. Ct. 757 (1941),* is particularly instructive:

Where, as in this case, the disputed amount was essentially a substitute for rental payments which §22(a) [of the 1932 Act] expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating right to such payments may be treated as "property" or "capital."

Id. at 31. The cancellation of the lease in Hort "involved nothing more than the relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises." *Id. at*

32. Because those future rents would have been taxed as ordinary income had they been received in the ordinary course of the lease, the "substitute" payment should be treated no differently. Id. Similarly, here, assuming the settlement was a "cancellation" of Taxpayer's contractual rights, what Taxpayer fought for, and received, is merely a substitute payment for the compensation and retirement benefits due him under his express and implied employment contracts. Because his salary and benefits would have been taxed as ordinary income without any offsetting basis if received in the ordinary course under Taxpayer's employment contract, the "substitute" payments can be treated no differently. See *Henry v. Commissioner, 62 T.C. 605, 606 (1974)* (holding that amounts received in settlement of breach of employment contract must be held impressed with the same compensatory, taxable character); cf. *Hodge v. Commissioner, 64 T.C. 616 (1975)* (addressing suit for back wages); *Stearns v. Commissioner, 14 T.C. 420 (1950)*, affd. per curiam *189 F.2d 259 (6th Cir. 1951)* (same).[7]

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[7] In support of their claim that Taxpayer's express and implied contracts were "intangible assets," Petitioners rely on a Fifth Circuit case and two revenue rulings holding that professional football or baseball player contracts were assets with distinct values that could be depreciated by the team owners. *Laird v. U.S., 556 F.2d 1224 (5th Cir. 1977)* (discussing professional football player contracts), cert. denied, *434 U.S. 1014, 54 L.Ed.2d 758, 98 S.Ct. 729 (1978); Rev. Rul. 77-137, 1971-C.*B. 104 (same); and *Rev. Rul. 67-379, 1967-2 C.B. 127* (same, baseball). Petitioners' reliance is clearly inapposite and unpersuasive. As the Tax Court noted, and as Petitioners concede, Taxpayer's employment contract with Young was neither a depreciable nor a capital asset in his hands.

Moreover, while Petitioners correctly maintain that Taxpayer's contract claims were ordinary, not capital, assets, *Furrer v.*

[footnote continued]

Similarly, Petitioners' argument that, because the settlement was a "cancellation" of his contractual rights, it was a "disposition" within the meaning of Section 1001(a), is unpersuasive. As the Tax Court correctly noted, assuming the settlement was a "cancellation" of Taxpayer's rights, it does not necessarily follow that the settlement constituted a "disposition" of "property" warranting an offsetting of basis. See *Herbert's Estate v. Commissioner, 139 F.2d 756 (Fed. Cir., 1943)* (discussing meaning of "disposition" and holding extinguishment of decedent's debt, represented by readily transferable notes and open accounts, was a disposition), cert. denied, *322 U.S. 752 (1944).*[8] More importantly, to

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Commissioner, 566 F.2d at 1117 (noting that "if all contracts granting rights could be considered capital assets, without inquiry into the nature of the rights granted, almost all ordinary income from salaries, wages, or commissions could be transformed into capital gain"), they nonetheless urge us to apply here the rationale adopted in a line of cases addressing the deductibility of legal fees incurred in the disposition of a capital asset. See *United States v. Hilton Hotels Corp., 397 U.S. 580, 25 L.Ed.2d 585, 90 S.Ct. 1307 (1970); Woodward v. Commissioner, 397 U.S. 572, 25 L.Ed.2d 577, 90 S.Ct. 1302 (1970); Helgerson v. United States, 426 F.2d 1293 (8th Cir. 1970); Baier v. Commissioner, 63 T.C. 513 (1975),* aff'd, *533 F.2d 117 (3d Cir. 1976);* see also *A.E. Staley Manufacturing Co. and Subsidiaries v. Commissioner, 1995 WL 535269* at 46-48, *105 T.C. (CCH) 14 (1995)* (providing a recent discussion of the "origin of the claim" analysis in the context of capital assets). These cases simply do not persuade us that Taxpayer's Legal Fee should be offset against the settlement proceeds because, as we have already explained, Taxpayer's Legal Fee was incurred to obtain damages in the nature of compensation due him under the express and implied employment contracts.

[8] As the Tax Court correctly noted, Petitioners' reliance on Herbert's Estate is inapposite. Petitioners fail to recognize that the nature of the claim involved proved an important factor in the court's finding of a "disposition." Unlike the executors in Her-

[footnote continued]

permit Taxpayer to offset his "cost of disposition" or basis—the Legal Fee—would be fundamentally inapposite in light of the controlling fact that the settlement proceeds are clearly in the nature of compensation as Young's employee.[9]

To recapitulate, what is relevant is that, as the Tax Court found, Taxpayer in substance was suing for damages suffered by the loss of his employment with Young —his loss of compensation in terms of salary and retirement benefits. This is a factual determination and, indeed, is one with respect to which we find no clear error. In fact, the claim giving rise to the Legal Fee is inexorably rooted in Taxpayer's employment with Young —indeed, in his status as Young's "employee."[10] Because

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bert's Estate, Taxpayer did not hold a claim against Young in the sense of a "debt," that was readily transferable or liquidated prior to settlement; nor, was he in any way Young's "creditor."

[9]One might intuitively argue that some sort of "basis" should be recognized when one has to litigate to receive one's due compensation. The fact remains, however, that the Code simply does not provide for the offsetting of basis in such circumstances except in limited cases involving capital assets. Instead, the Code permits litigation expenses to be taken into account by way of a deduction. See Section C, infra.

[10]We note also that under this rubric it is irrelevant that at the time of the lawsuit, Taxpayer was no longer on Young's payroll. See footnote 14, supra, and related text. Equally irrelevent is Taxpayer's stated purpose for incurring the Legal Fee, namely "to add value to [Taxpayer's] contract claims, and to dispose of those assets by means of either a settlement or a courtroom victory." See *Woodward, 397 U.S. at 578* (rejecting purpose test and noting that it would encourage a resort to formalisms and artificial distinctions); *U.S. v. Gilmore, 372 U.S. 39, 49, 9 L.Ed.2d 570, 83 S.Ct. 623 (1963)* (rejecting purpose test in favor of origin of claim test). Taxpayer's desire to obtain the salary and benefits due under the employment contracts was clearly the "origin" of the lawsuit – not his alleged desire to "dispose" of "intangible assets."

the damages Taxpayer received are essentially a substitute for the salary and benefits he would have received under the employment contract, they are fully included as ordinary income in Taxpayer's gross income under Section 61, without regard to whether Taxpayer's employment contracts constituted "property" or "intangible assets." *Horst, 313 U.S. at 31-32.*[11]

Thus, upon de novo review, we find no error of law in the Tax Court's rejection of Petitioners' arguments in favor of Section 1001 treatment, because the settlement proceeds were received in lieu of compensation and, as such, are fully included as gross income under Section 61.

C. Deductibility of the Legal Fee

Having determined that the Legal Fee is included in gross income under Section 61, we turn to the question of its deductibility. It is well-settled that any accessions to wealth received by a taxpayer are included in his gross income, unless the taxpayer can demonstrate that the amount received falls within a specific statutory exclusion. *Commissioner v. Glenshaw Glass, 348 U.S. 426, 431, 99 L. Ed. 483, 75 S. Ct. 473,* reh'g denied, *349 U.S. 925, 99 L. Ed. 1256, 75 S. Ct. 657 (1955).* Section 162(a) provides that there "shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 62(a)(1) adds that expenses falling within Section 162(a) are deducted from gross

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[11] We note that we need not address the merits of Petitioners' claim regarding Sections 1001 and 1016, namely that because those two sections make no distinction between the basis and gain rules for capital or ordinary assets, "there is a 'capital account' for all assets."

income to arrive at "adjusted gross income," explicitly excluding expenses incurred by a taxpayer engaged in the trade or business of the performance of services as an employee.[12]

Petitioners argue that, if the entire settlement proceeds allocable to Counts I and II constitute gross income to him under Section 61(a) of the Code, the Legal Fee should be treated as an "above the line" trade or business expense under Section 162(a) of the Code, rather than a "miscellaneous itemized deduction" under Section 63, as the Commissioner found and the Tax Court held. The crux of Petitioners' argument is that the "employee" limitations of Section 62(a)(1) do not apply, because Taxpayer was not Young's employee during 1989. Pointing to the fact that Taxpayer was employed in 1989 as an independent management consultant, they maintain that the Tax Court's application of Section 62(a)(1) is based on its erroneous finding that Taxpayer was "in the business of performing services of an employee" during 1989.

We disagree with Petitioners. First, we reiterate that we find no clear error in the Tax Court's determination finding that Taxpayer was "in the business of performing services of an employee" during 1989.[13] Second, we look

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[12]Section 62(a)(1) provides in pertinent part,

> The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

26 U.S.C. Section 62(a)(1) (1988 & Supp. 1991) (emphasis added).

[13]It is well-settled that an individual may engage in the trade or business of rendering services as an employee. *McKay*

[footnote continued]

to the plain language of Section 62(a)(1). As the Tax Court correctly noted, no distinction is made in Section 62(a)(1) between present and former employees if the expenses originated in the trade or business of being an employee.[14] Thus, the fact that Taxpayer was not in actuality Young's employee in 1989 does not alter the controlling fact that the lawsuit and the ensuing settlement directly resulted from his employment with Young. Petitioners argue in vain that Taxpayer should not be "saddled with employee status" because his new trade or business as an independent management consultant indicates a "break" from his former employment with Young (Appellants' Brief, p. 40). Equally in vain, they argue that the "lawsuit should be looked at as the ordinary and necessary expense incurred by an independent businessman to bring suit when contracts are breached." (Appellants' Brief, p. 40). As the Tax Court correctly found, there is absolutely no connection between Taxpayer's lawsuit and his independent management consulting business. Instead, Taxpayer's lawsuit was "directly connected with, or ... proximately resulted from" his em-

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v. Commissioner, 102 T.C. 465, 489 (1994), appeal docketed, No. 94-41189 (5th Cir. 1995) (collecting cases).

[14] *See McKay, 102 T.C. at 489* (holding corporate executive's post-employment litigation expenses incurred in suit against former employer were incurred in trade or business, and were deductible, if at all, under Section 162); *McKeague v. United States, 12 Cl. Ct. 671, 674-77 (1987)* (finding, inter alia, that former employee's litigation expenses which originated in trade or business were deductible as ordinary expenses under Section 162), aff'd without published opinion, *852 F.3d 1294 (Fed. Cir. 1988)*; cf. *Kornhauser v. United States, 276 U.S. 145, 153, 72 L.Ed. 505, 48 S.Ct. 129 (1928)* (stating that where suit against a taxpayer is directly connected with, or proximately resulted from, his business, expense incurred is a business expense).

ployment at Young.[15] *Kornhauser, 276 U.S. 145 at 153, 72 L. Ed. 505, 48 S. Ct. 219.* It is under this rubric that Taxpayer is considered to be in the business of being Young's "employee" for purposes of falling within the Section 62(a)(1) limitation.[16]

In another attempt to circumvent the application of Section 62(a)(1), Petitioners argue that, if we attribute employee status to Taxpayer, we should find that Young's direct payment of the settlement proceeds to R&W (by way of joint checks payable to Taxpayer and R&W as joint payees) qualifies as a reimbursement arrangement within the meaning of Section 62(a)(2)(A). That section provides that reimbursed employee expenses are permitted to be deducted from gross income when arriving at adjusted gross income.[17] Peti-

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[15]We note also that on the "Disclosure Under Reg. Sec. 1.6661," Petitioners' tax preparer describes the lawsuit against Young as being for "age discrimination, back wages and retirement benefits." (Appellants' Appendix, p. 68). We also note that the releases executed pursuant to the Settlement Agreement regard "all claims arising out of [Taxpayer's] employment by [Young] and the cessation of [Taxpayer's] employment" and "all claims which were or could have been asserted by [Taxpayer] in the Lawsuit entitled J. Kenneth Alexander v. W.F. Young, Inc., Hampden Superior Court Civil Action No. 88-243." (Appellants' Appendix, p. 98).

[16]Similarly irrelevant is Petitioners' argument that the Legal Fee was not expended for the benefit of Young's business and was in fact detrimental to Young. See *McKay, 102 T.C. at 488, n.23* (noting that "it makes no difference whether the employee is defending himself in actions that challenge his activities as a corporate officer or the employee is bringing a suit against his former employer."); see also *McKeague, 12 Cl. Ct. 671* (involving litigation expenses which were not incurred for benefit of taxpayer's employer).

[17]Section 62(a)(2)(A) provides, in pertinent part, that in determining adjusted gross income there will be allowed, the de-

[footnote continued]

tioners contend that Young's direct payment arrangement was effectively providing for the payment of the Legal Fee pursuant to Section 62(a)(2)(A) in light of the fact that R&W had a statutory lien under Massachusetts law for the payment of the Legal Fee. See Mass. Gen. L. ch. 221, sec. 50 (1986). This argument fails because it is utterly without support in the record. As the Tax Court correctly found, Petitioners have not proven that Taxpayer was under a "reimbursement or other expense allowance arrangement" with Young for Taxpayer's Legal Fee. Contrary to Petitioners' insistence, the fact that the record shows Young's direct and joint payment is "standard operating procedure.. in all types of litigation does not support the requisite finding of a reimbursement or other "arrangement" or alter the fact that both Young and Taxpayer were responsible for their respective legal costs. Finally, we also note that the settlement agreement itself makes no mention of attorney's fees and the Taxpayer's lawsuit was dismissed "without prejudice and without costs." Thus, we reject Petitioners' argument that Section 62(a)(2)(A) applies, and reaffirm our conclusion that the Legal Fee falls squarely within Section 62(a)(1).

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ductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that reimbursement may be provided by a third party shall not be determinative of whether or not the preceding sentence applies. *26 U.S.C.* §*62* (1988 & Supp. 1991) (emphasis added); see H.R. Conf. Rep. No. 998, 100th Cong., 2d Sess. at 204. (allowing reimbursed expenses only if incurred pursuant to a reimbursement or other expense allowance arrangement requiring employees substantiate expenses covered thereunder to the person providing the reimbursement).

Having determined that Section 62's employee limitation applies, we turn to its effect on Taxpayer's Legal Fee. Expenses excluded under the Section 62(a)(1) limitation are treated as "itemized deductions" under Section 63, such that they are subtracted from adjusted gross income in computing the taxpayer's "taxable income." See *I.R.C.* §*63(d)* (stating that "itemized deductions" include all deductions not "allowable in arriving at adjusted gross income" and the deduction for personal exemptions provided by Section 151). In turn, under Section 67(b) "miscellaneous itimized deductions" —which are defined as all itemized deductions other than those specifically enumerated therein—are subject to a 2-percent floor, such that they are allowable "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Because trade or business expenses subject to Section 62(a)(1), such as Taxpayer's Legal Fee, are not among the deductions listed in Section 67(b), statutory construction leads to the conclusion that they are miscellaneous itemized deductions subject to the 2-percent floor. See *McKay, 102 T.C. at 493*;[18] cf. *In Re Black, 131 Bankr. 106, 108 (E.D. Ark. 1991)* (discussing the deductibility of non-reimbursed employee business expenses).

Upon de novo review, and finding no merit to Petitioners' other arguments, we therefore affirm the Tax Court's determination that the Legal Fee is properly deducted "below the line."

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[18] We note that, without advancing much by way of argument, Petitioners urge us not to follow McKay (and its statutory analysis), claiming that it is wrongly decided. We merely add that, upon de novo review, we agree with McKay's statutory analysis, and find the case on point.

D. Applicability of Alternative Minimum Tax

Petitioners do not dispute that the treatment of Taxpayer's Legal Fee as a miscellaneous itemized deduction triggers the application of the Alternative Minimum Tax (the "AMT") under Sections 55 and 56;[19] nor do they deny that, under Section 56(b)(1)(A)(i), they are not permitted to deduct the Legal Fee as a miscellaneous itemized deduction (as defined in Section 67(b)) in computing the AMT. Petitioners do argue, however, that the Commissioner's "stretching" interpretation of Section 62(a)(1), adopted by the Tax Court and, now, this Court, results in "gross injustice, inequity and lack of uniformity in the treatment of taxpayers similarly situated." (Appellants' Brief, p. 24).

We recognize that, because the amounts involved trigger the AMT and, thus, Taxpayer's deficiency, the outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment. While unfortunate for Petitioners here, we disagree that there is inequality of treatment as compared to similarly situated taxpayers. Although it may seem otherwise, in reality Petitioners have not been denied their below the line deduction of the Legal Fee.

The AMT was enacted to "ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." S. Rep. No. 313, 99th Cong., 2d Sess. at 518, 1986-3 C.B. (Vol. 3) v., 518; see also S. Rep. No. 1263, 95th Cong., 2d Sess., *1978-1 C.B. (Vol. 1) 315, 499.* It is well established that equitable arguments cannot overcome the plain meaning of the statute. See *Okin v. Commis-*

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[19] *26 U.S.C.* §§*55* and 56 (1988 & Supp. 1991).

sioner, 808 F.2d 1339, 1340-42 (discussing the purpose and constitutionality of the AMT), cert. denied, *484 U.S. 802, 98 L. Ed. 2d 10, 108 S. Ct. 45 (1987); Warfield v. Commissioner, 84 T.C. 179, 184 (1985)* (rejecting argument that imposition of the AMT was unfair because income-producing transaction was only a "one-time deal;" "there is no justification for creating such an exception to the express terms" of Section 55); see also *Rawlins v. Commissioner, 1995 WL 610605,* at 5-8, *T.C. Memo 1995-502, 70 T.C.M. (CCH) 1046, (1995).* Petitioners are bound by the tax consequences of the settlement as it actually occurred. *84 TC at 184.*

III. CONCLUSION

For the foregoing reasons, we affirm the Tax Court's decision and uphold the Commissioner's finding of Petitioners' deficiency. The judgment of the Tax Court is affirmed.

APPENDIX I

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 94-5063

JACK L. BAYLIN, Tax Matters Partner,
Painters Mill Venture,
Plaintiff-Appellant,

v.

THE UNITED STATES,
Defendant-Appellee.

43 F.3d 1451; 1995 U.S. App. LEXIS 91;
95-1 U.S. Tax Cas. (CCH) P50,023;
75 A.F.T.R.2d (RIA) 383

January 5, 1995, Decided

PRIOR HISTORY:
Appealed from: U.S. Court of Federal Claims. Judge Yock.

DISPOSITION:
AFFIRMED

COUNSEL:
Theodore William Hirsh, Miles & Stockbridge, of Baltimore, Maryland, argued for plaintiff-appellant. With him on the brief was Ann M. Sheridan.

Bruce Ellison, Department of Justice, of Washington, D.C., argued for defendant-appellee. With him on the brief were Loretta C. Argrett, Assistant Attorney General, Gary R. Allen and Sara S. Holderness, Attorneys.

JUDGES:
Before RICH, MAYER, and SCHALL, Circuit Judges.

OPINIONBY:
MAYER

OPINION:

MAYER, Circuit Judge.

On cross-motions for summary judgment, the United States Court of Federal Claims granted the government's motion and held that the legal fees of the Painters Mill Venture were a capital expenditure and that the portion of the condemnation award paid to its attorney under a contingency fee agreement was gross income to the partnership. *Baylin v. United States, 30 Fed. Cl. 248 (1993).* We affirm.

Background

Baylin is the tax-matters partner of Painters Mill Venture, a partnership, which owned 137 acres of land condemned by the State Roads Commission of the Maryland State Highway Administration under state law "quick-take" provisions. See Md. Code Ann., Transp. §§8-334 to -339 (repl. vol. 1993); *30 Fed. Cl. at 249.* Pursuant to those provisions, the government deposited $2,699,775, its estimate of the fair market value of the property, in the registry of the Baltimore County Circuit Court. The partnership disagreed with that estimate and filed suit in state court, and a jury awarded the partnership $3,899,000 plus interest and costs. See *id. at 250.*

When the partnership decided to appeal this condemnation award, it entered into a contingency fee arrangement with its attorney under which it agreed to pay him a percentage of any amount recovered above the previous award. See *id. at 251.* The appeals court determined that the trial court used the wrong standard for valuation of the property and remanded for a new valuation. The state then proposed a settlement of $10,114,250, including interest. After further negotiations, the parties agreed to a settlement of $16,319,522.91, and the trial court entered a stipulated judgment in that amount in January of 1989. See id. The partnership received its condemnation award and interest between 1981 and 1988 in slightly different amounts than what was in the stipulated judgment—namely, $10,625,850 in principal and $6,358,418 in interest.* The partnership's legal expenses for the appeal amounted to $4,048,424. See *id. at 252.*

In 1988, the partnership reported a capital gain of $7,297,828 on the property.** It arrived at that figure by substracting from the principal portion of the condemnation award the purchase price of the property and the portion of its legal fees that it attributed to recovery of principal. See id. The partnership deducted from interest income the remaining portion of the legal fees, which it attributed to recovery of the interest portion of the

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*The Court of Federal Claims incorrectly stated that interest payments totalled $6,432,416, because the court twice added a payment of $73,998 made in 1988. See *30 Fed. Cl. at 251.*

**The partnership had deferred recognition of the capital gain under *I.R.C.* §*1033.* See *26 U.S.C.* §1033 (1988). Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, *26 U.S.C.* §§ *1-9722,* as amended of the taxable year in question.

award and thus regarded as a deductible ordinary and necessary business expense "paid or incurred ... for the production or collection of income." *26 U.S.C. §212 (1)* (1998).

The IRS classified all of the legal fees as a capital expenditure and calculated a capital gain of $5,274,964 by adding all of the legal fees to the basis of the condemned property. Total taxable interest income for 1988, according to the IRS, equalled $6,205,273. The partnership challenged the IRS's calculations in the Court of Federal Claims, which agreed with the IRS and granted summary judgment in favor of the government. See *30 Fed. Cl. at 259.*

Discussion

The parties agree that the portion of the partnership's legal expenses attributable to its attorney's efforts to increase the principal portion of its condemnation award is a nondeductible capital expense under *section 163(a) of the Internal Revenue Code* of 1986. See *26 U.S.C. §263*(a) (1988). They disagree, however, over the proper measure of the legal fees attributable to that capital expense. The partnership contends that it should be allowed to deduct from interest income an amount of its attorney's fees proportionally equivalent to the amount of the settlement classified as interest. In other words, because approximately one-half of the partnership's additional recovery following its appeal represented interest on the condemnation award, and because the partnership paid its attorney a percentage of the entire additional recovery, the partnership believes that approximately one-half of its legal fees, or approximately $2,000,000, should be deducted from the interest income under section 212(1).

The partnership is correct that legal fees may, under certain circumstances, be partially deductible and partially nondeductible. See, e.g., *Treas. Reg. §1.212-1(k)* (as amended in 1972 and 1975). But under the "origin of the claim" test it may not base the tax treatment of the legal fees on the relative amounts of principal and interest income ultimately received. Under that test, established by the Supreme Court in *United States v. Gilmore, 372 U.S. 39, 9 L. Ed. 2d 570, 83 S. Ct. 623 (1963),* and developed more fully in *Woodward v. Commissioner, 397 U.S. 572, 25 L. Ed. 2d 577, 90 S. Ct. 1302 (1970),* the proper focus is not the proportional recovery of each type of income, but the "origin and character of the claim" with respect to which the legal fees at issue were incurred. *Woodward, 397 U.S. at 578.* This court has explained that, "under the origin of the claim test, if the origin of an expenditure is capital in nature (such as the ... disposition of a capital asset), the expenditure is not deductible as an ordinary business expense, irrespective of the taxpayer's motivation for making the expenditure." *Stokely-Van Camp, Inc. v. United States, 974 F.2d 1319, 1324 (Fed. Cir. 1992).*

Here, the origin of the partnership's claim is in the disposition of its land. Under procedures established by the Maryland legislature, the partnership successfully disputed the state's estimate of the value of its land and later successfully argued that the Maryland trial court had used an improper method of valuation and that the land's value was, as a result, higher than either the state's estimate or the original jury award. We thus agree that "the origin of the claim can be traced to a set of statutes that are meant to provide an alternative when/if price negotiations are unsuccessful." *30 Fed. Cl. at 255.* Ef-

forts to increase the price of property are properly characterized as "part of the process of property disposition." Id.; accord *Isaac G. Johnson & Co. v. United States, 149 F.2d 851, 852 (2d Cir. 1945).* Costs related to property disposition are capital expenditures. See, e.g., *Woodward v. Commissioner, 397 U.S. 572, 575, 25 L. Ed. 2d 577, 90 S. Ct. 1302 (1970).*

The partnership's emphasis on the fact that the attorney's fees were paid out of the entire recovery—both principal and interest—is thus misplaced. This argument rests on the unsupported assumption that approximately half of the legal fees were paid for the collection of income simply because approximately half of the eventual recovery was interest income and approximately half of the legal fees were paid out of that income under the partnership's fee agreement with its attorney. The relative portion of the recovery that was labeled interest does not necessarily approximate the fees incurred to produce that income. To the contrary, the evidence presented on the attorney's allocation of his time suggests that he spent a de minimis amount attempting to increase the interest portion of the award. See *30 Fed. Cl. at 257;* cf. *Crews v. Commissioner, 1994 Tax Ct. Memo LEXIS 68, 67 T.C.M. (CCH) 2189, 1994 T.C. Memo 64 (1994)* (holding that three percent of the company's attorneys' fees were deductible because the attorney presented proof that three percent of his time was spent in supplemental hearings to establish the rate of prejudgment interest on a condemnation award).

A taxpayer must prove each deduction from income. See *Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593, 87 L. Ed. 1607, 63 S. Ct. 1279 (1943)* ("An income tax deduction is a matter of legislative grace and ... the burden of clearly showing the right to the claimed

deduction is on the taypayer."). Here, the partnership did not meet that burden. The entire legal fee was a capital expense under the origin of the claim test.

The partnership argues alternatively that, because the attorney was paid a portion of the condemnation recovery directly under the contingency fee agreement, that portion of the recovery was never part of the partnership's gross income. Very little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership to escape taxation on a portion of its income through a "skillfully devised" fee arrangement. *Lucas v. Earl, 281 U.S. 111, 115, 74 L. Ed. 731, 50 S. Ct. 241 (1930)* (Holmes, J.). *Section 61(a) of the Internal Revenue Code* provides that "gross income means all income from whatever source derived," and the Supreme Court "has given a liberal construction to the broad phraseology of the 'gross income' definition statutes in recognition of the intention of Congress to tax all gains except those specifically exempted." *James v. United States, 366 U.S. 213, 219, 6 L. Ed. 2d 246, 81 S. Ct. 1052 (1961).*

Here, although the partnership did not take actual possession of the funds it paid to its attorney, opting instead to pay him directly out of its eventual recovery, it is evident that the partnership received the benefit of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount. The fee arrangement signifies the value that the parties places on the attorney's services. In other words, the partnership "made such use or disposition of [its] power to receive ... the income as to procure in its place other satisfactions which are of economic worth." *Helvering v.*

Horst, 311 U.S. 112, 116, 85 L. Ed. 75, 61 S. Ct. 144 (1940). That the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery and by having the obligation of the client to the attorney discharged by having the state pay the attorney his fees directly from the recovery. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees.

The partnership also relies on a Maryland statute that gives an attorney a lien on "attorney's fees and compensation specially agreed on with the attorney's client." Md. Ann. Code art. 10, §46 (repl. vol. 1987), recodified at Md. Code. Ann. Bus. Occ. & Prof. §10-501 (1989). The argument that this statute gives the attorney an ownership interest in those funds is unsound. Maryland courts have not interpreted the state's lien statutes as creating such an interest. See, e.g., *Chanticleer Skyline Room, Inc. v. Greer, 271 Md. 693, 319 A.2d 802, 806 (Md. 1974)* ("Like any other lien, this lien does not create an ownership interest in the attorney, but merely places a charge upon the fund as security for the debt which is owed to the attorney by his client." (Emphasis added)). The partnership's "contention that it had no right to or ownership in that portion of the condemnation proceeds it owed to its attorney under the contingency fee agreement is simply without legal basis," *30 Fed. Cl. at 258,*

and the entire condemnation award was properly considered gross income to the partnership.

Conclusion

Accordingly, the judgment of the Court of Federal Claims is affirmed.

AFFIRMED